S. HRG. 113–20

BIPARTISAN SOLUTIONS FOR HOUSING FINANCE REFORM?

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

ON

DISCUSSING HOUSING FINANCE REFORM AND SUGGESTIONS FOR IMPROVING THE CURRENT HOUSING MARKET AND PROVIDING STABILITY IN THE FUTURE

MARCH 19, 2013

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.fdsys.gov/

U.S. GOVERNMENT PRINTING OFFICE

81–201 PDF WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

TIM JOHNSON, South Dakota, *Chairman*

JACK REED, Rhode Island
CHARLES E. SCHUMER, New York
ROBERT MENENDEZ, New Jersey
SHERROD BROWN, Ohio
JON TESTER, Montana
MARK R. WARNER, Virginia
JEFF MERKLEY, Oregon
KAY HAGAN, North Carolina
JOE MANCHIN III, West Virginia
ELIZABETH WARREN, Massachusetts
HEIDI HEITKAMP, North Dakota

MIKE CRAPO, Idaho
RICHARD C. SHELBY, Alabama
BOB CORKER, Tennessee
DAVID VITTER, Louisiana
MIKE JOHANNS, Nebraska
PATRICK J. TOOMEY, Pennsylvania
MARK KIRK, Illinois
JERRY MORAN, Kansas
TOM COBURN, Oklahoma
DEAN HELLER, Nevada

CHARLES YI, *Staff Director*
GREGG RICHARD, *Republican Staff Director*

LAURA SWANSON, *Deputy Staff Director*
GLEN SEARS, *Deputy Policy Director*
ERIN BARRY FUHRER, *Professional Staff Member*
BETH COOPER, *Professional Staff Member*
WILLIAM FIELDS, *Legislative Assistant*

GREG DEAN, *Republican Chief Counsel*
CHAD DAVIS, *Republican Professional Staff Member*

DAWN RATLIFF, *Chief Clerk*
KELLY WISMER, *Hearing Clerk*
SHELVIN SIMMONS, *IT Director*
JIM CROWELL, *Editor*

C O N T E N T S

TUESDAY, MARCH 19, 2013

	Page
Opening statement of Chairman Johnson	1
Prepared statement	15
Opening statements, comments, or prepared statements of:	
Senator Crapo	2
Senator Vitter	3
Senator Menendez	
Prepared statement	33

WITNESSES

Mel Martinez, Co-Chair, Bipartisan Policy Center's Housing Commission	5
Prepared statement	33
Response to written questions of:	
Senator Menendez	122
Peter J. Wallison, Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute	7
Prepared statement	41
Response to written questions of:	
Senator Menendez	128
Janneke Ratcliffe, Senior Fellow, Center for American Progress Action Fund	9
Prepared statement	111
Response to written questions of:	
Senator Menendez	131

BIPARTISAN SOLUTIONS FOR HOUSING FINANCE REFORM?

TUESDAY, MARCH 19, 2013

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:11 a.m. in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. Last Congress, the Banking Committee held 18 hearings regarding housing finance reform and suggestions for improving the current housing market and providing stability in the future. I look forward to continuing that conversation with the new Ranking Member and the new Members of the Committee.

I would like to thank the witnesses in advance for contributing to what I hope will be a lively and substantive debate about bipartisan solutions for housing finance reform. I would also like to commend the BPC's Housing Commission for producing a plan with broad support from both sides of the aisle.

For housing finance reform to succeed, we must find areas of bipartisan consensus. A partisan bill or a bill full of ideology that ignores the realities of our economy would be irresponsible, especially when the housing market is beginning to show signs of strength. I will work with Ranking Member Crapo to establish a series of hearings to explore the issues that require more discussion before we can achieve a consensus bill.

When the housing market began to decline, the Government took on a larger role—nearly 90 percent of the market. In previous hearings, witnesses testified that without Fannie Mae, Freddie Mac, and FHA providing liquidity, most families would not have been able to get a mortgage during the economic crisis. Witnesses also pointed out that, without Government involvement, the traditional 30-year, fixed-rate mortgage would be priced out of reach for most borrowers, if it remained available at all. Now that the housing market is showing signs of strength, private capital is starting to return to the market.

While the participation of private capital is essential for the health of our economy, I am concerned that a completely private housing finance system would place home ownership out of reach for many middle-income families and rural communities like those in my home State of South Dakota. I am not interested in creating

a system in which home ownership is only available to the few and most fortunate.

We must find workable solutions that preserve the option of sustainable home ownership for future buyers and provide adequate financing for multifamily construction for those who prefer to rent or cannot afford to own a home. I look forward to hearing the suggestions of our witnesses.

With that, I will turn to Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you, Mr. Chairman.

On September 7, 2008, then-FHFA Director James Lockhart stood jointly with then-Treasury Secretary Henry Paulson to announce that Fannie Mae and Freddie Mac were being placed into conservatorship. In describing the situation as a "time-out," Secretary Paulson stated:

> We will make a grave error if we do not use this time-out to permanently address the structural issues presented by the GSEs. In the weeks to come, I will describe my views on long-term reform. I look forward to engaging in that timely and necessary debate.

It seems unlikely that anyone envisioned the time-out lasting 5 years, costing taxpayers nearly $190 billion. Further, during this time-out, we still have not had that timely and necessary debate, and I thank the Chairman for getting us into that process now.

These conservatorships were designed to be temporary, but with each day that passes, Fannie Mae and Freddie Mac become further entrenched within our Government. According to the most recent conservators' report, Fannie Mae, Freddie Mac, and Ginnie Mae controlled 100 percent of the mortgage-backed securities, or MBS, market in the United States during the first three quarters of 2012. One hundred percent.

Since 2008, these governmental entities have controlled no less than 95 percent of that market in any given year. Simply put, much of the private market has not been able to re-enter the market and compete with the Federal Government.

What do the monetary policies of the Federal Reserve and their buying large amounts of mortgage-backed securities do to that? Those able to obtain credit are not yet fully feeling the effects of a market lacking private participation and innovation. Presumably, though, this subsidy will someday end, and at that time all consumers will suffer if our markets have not been allowed to evolve for an extended period of time.

An equally disappointing byproduct of the current situation is the growing urge by some to use the conservatorships as piggy banks. Two years ago, the guarantee fee charged by Fannie and Freddie was increased, not to insure against risk but to pay for an unrelated tax cut. This increase, which is nothing less than a hidden tax on home buyers, will last for 10 years, even though it paid for a tax cut that lasted only 2 months.

Unfortunately, the proposed Senate budget that we are currently considering would further extend that tax to pay for new spending. I was pleased to see a bipartisan group of Senators from this Committee—Senators Corker, Warner, Vitter, and Warren—who recently introduced legislation that would prohibit this.

I, too, have long had concerns about this, so I am glad to see that we have a bipartisan consensus building against this practice. Hopefully together we can correct this wrongful policy on the floor.

However, regardless of that outcome, this new attempt reminds of us of the importance of ending these conservatorships. It is my hope that this hearing can serve to reignite discussions on how to proceed with reform of our Nation's housing market.

There has been little movement on this since the Administration released a brief white paper more than 2 years ago. Within the amendment and across this Committee, there is certainly a wide range of views as to what would be the optimal solution. Some of these differences will be discussed today, and that is productive. However, for far too long, our differing views as to the optimal solution seem to have prevented substantive negotiations from even starting.

While it is true that today we do not even agree on what should be the final product, this should not preclude us from beginning negotiations or even jointly identifying problems in today's market.

Mr. Chairman, again, I thank you for holding this hearing, and I stand ready to work with you and am eager to begin necessary bipartisan negotiations that will help us to end these conservatorships.

Thank you.

Chairman JOHNSON. Thank you, Senator Crapo.

Are there any other Members who wish to make a brief opening statement? Senator Vitter.

STATEMENT OF SENATOR DAVID VITTER

Senator VITTER. Thank you very much, Mr. Chairman. I appreciate the opportunity. I will be very brief, and, unfortunately, I cannot stay for the remainder of the hearing. But I also wanted to thank you for this additional hearing on mortgage finance reform and to encourage bipartisan Committee action on this.

Specifically, I did want to underscore what Senator Crapo just mentioned, this jump-start GSE reform bill that was recently introduced by Senators Warner and Corker and myself and Senator Warren. This is a bipartisan, realistic approach, a good start which fits the parameters that you described, and I think it is fully consistent with the process you described. And, therefore, we would urge you to schedule a markup of this bill in April.

Again, the bill has broad bipartisan support and wide industry support, including specifically the Mortgage Bankers Association and the National Association of Realtors. Let me just quote briefly those two groups.

MBA said, "It is imperative that Congress as well as the White House and key members of the housing community come together to create a comprehensive, transparent process that properly addresses the concerns and objectives of all affected stakeholders involved with GSE reform." And they specifically support and endorse our bill.

And the realtors wrote, "The prevailing thought among NAR's members is: until housing finance reform is completed, specifically reform of the Government-sponsored enterprises Fannie Mae and

Freddie Mac, housing will continue to limp along in a state of purgatory."

Mr. Chairman, we are 5 years now removed from the start of our crisis. We have passed major legislation, and yet in all of that, four words have been missing completely: "Fannie Mae, Freddie Mac." I think it is absolutely time to start acting in this area, and I think our legislation is a very good, reasonable, bipartisan start. And so I would urge a markup in April, if at all possible, as I suggested.

Thank you very much for your leadership.

Chairman JOHNSON. Thank you, Senator Vitter.

I would note that this bill and Senators Menendez and Boxer's refinancing bill are both commonsense measures, and they should move forward together. I look forward to working with Ranking Member Crapo and other Members of the Committee to accomplish this.

Senator Tester?

Senator TESTER. Thank you, Mr. Chairman. I appreciate you holding this hearing today. I certainly believe there are some areas of bipartisan agreement on this issue with housing finance reform, at least from my conversation with folks on this Committee.

As our housing market shows some signs of strengthening, I think it is time for us to be working toward solutions, and I look forward to working with you, Mr. Chairman and Ranking Member Crapo, to build consensus within the Committee on the future of housing finance reform.

Now, Montana's housing market has seen its share of challenges over the past several years, but trouble areas are showing new signs of strength. And when I talk to folks across my State, they are tired of the rhetoric, and they agree that it is time for policymakers to begin making implement decisions about the future of housing finance. And I think many of us agree that we need to bring back more private capital to mortgage markets and to bear additional risk to better protect taxpayers, and that we should preserve the option of a traditional 30-year, fixed-rate mortgage.

Being from rural American, from my perspective one of the most important assets of any future housing finance reform system is that small financial institutions that serve rural America remain on equal footing with the big guys when it comes to accessing the secondary market. If these communities banks and credit unions are cut out of the picture, then so, too, would many of the rural communities across this country be cut out. Rural communities are served and served well by small community-based institutions, so anything that would put them at a disadvantage would be a death knell for rural America.

I want to thank the Committee Members for being here this morning. I look forward to your testimony, and I look forward to the questions and answers that follow thereafter. A special welcome back to Senator Mel Martinez.

Chairman JOHNSON. Anyone else?

[No response.]

Chairman JOHNSON. Thank you all.

I want to remind my colleagues that the record will be open for the next 7 days for opening statements and any other materials you would like to submit.

Now I would like to introduce our witnesses.

The Honorable Mel Martinez is the co-chair of the Bipartisan Policy Center's Housing Commission. Senator Martinez served in the Senate and as a Member of this Committee from 2005 to 2009. Senator Martinez also served as Secretary of Housing and Urban Development from 2001 to 2003. I welcome our colleague back to the Committee.

The Honorable Peter Wallison is the Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute. Mr. Wallison also served as a general counsel for the Treasury Department during the Reagan administration.

And, finally, Ms. Janneke Ratcliffe is a senior fellow at the Center for American Progress and the Executive Director of the Center for Community Capital at the University of North Carolina.

Senator Martinez, please begin your testimony.

STATEMENT OF MEL MARTINEZ, CO-CHAIR, BIPARTISAN POLICY CENTER'S HOUSING COMMISSION

Mr. MARTINEZ. Mr. Chairman, thank you very much, and Senator Crapo and Members of the Committee. It is a real pleasure to be back with all of you friends and to have an opportunity to talk about an issue that I know we all care a great deal about.

I have been privileged to serve as one of the co-chairs of the Bipartisan Policy Center's Housing Commission, and along with former Senator George Mitchell, Senator Kit Bond, and former Secretary of Housing Henry Cisneros. We are the co-chairs. And there was another group of another 21 people from both sides of the aisle with expertise in a variety of areas, the whole housing gamut.

Over the last 16 months, we met and had a lot of conversation about what the future of housing should be. We issued a report last month, and it covers home ownership, affordable rental housing, rural housing, and the housing needs of our Nation's seniors. Today I am going to highlight for you and discuss the recommendations of the report as it relates to housing finance.

So as has been pointed out, our housing finance system is broken. It has been more than 4 years since Fannie Mae and Freddie Mac were placed into Government conservatorship, with no clear path forward even now. So the commission felt that there was an opportunity to fill this policy void and offer a blueprint for a new system that can support both the home ownership and rental markets for years to come. The commission reached consensus on five key objectives for this new system.

Our first objective is a far greater role for the private sector in bearing credit risk. The dominant position of the Government, as was pointed out by Ranking Member Crapo, is 100 percent currently in this current time, and more than 95 percent for the last several years. This is unsustainable. Private capital is now flowing through the system, but it absorbs very little of the system's credit risk. Instead, much of that risk lies with the Government. Nearly 90 percent of the single-family home ownership market remains Government supported, and reducing the Government footprint and encouraging more private participation will protect taxpayers while providing for a greater diversity of funding sources.

The second objective is a continued, but much more limited, role for the Federal Government as the insurance backstop of last resort. The commission recommends the establishment of an explicit, but very limited, Government guarantee administered by a new entity that we call the "Public Guarantor" to ensure timely payment of principal and interest on qualified mortgage-backed securities. There really just is insufficient capacity on bank balance sheets alone to meet our Nation's mortgage finance needs. A strong, vibrant secondary market for these securities is essential to freeing up additional capital for mortgage lending and connecting our Nation's local housing markets to global investors.

Investors in the secondary market require a Government guarantee protecting against catastrophic credit risk. These investors are willing to assume the risk of interest rate volatility, but they are unwilling to participate as a practical matter to underwrite the hundreds, if not thousands, of mortgages that make up mortgage-backed securities. In the absence of this catastrophic guarantee, investor interest in the secondary market would wane, mortgage credit would become more expensive, and widespread access to affordable, fixed-rate mortgage financing—particularly a 30-year mortgage—would disappear.

In our proposal, the Government stands in the "fourth loss" position behind three layers of private capital: mortgage borrowers and their home equity; private credit enhancers, ranging from capital market products to highly capitalized mortgage insurers; and the corporate resources of the securities' issuers and mortgage servicers. These private companies would be subject to stringent capital requirements that would enable them to weather losses similar in magnitude to those experienced during the Great Recession.

The limited Government guarantee would kick in only after the private credit enhancers standing ahead of it had depleted all of their resources. Even then, these losses would be paid for through a fully funded catastrophic risk fund capitalized through the collection of insurance premiums over time, or guarantee fees, from mortgage borrowers. In many respects, this model is very similar to today's Ginnie Mae.

The third objective is the ultimate elimination of Fannie Mae and Freddie Mac over a transitional period—perhaps 5 to 10 years. And like other observers, the commission believes the business model of the two Government-sponsored enterprises—publicly traded companies with an implied Government guarantee and other advantages—should not be reproduced.

The commission recognizes that a dynamic and flexible transition period will be necessary before the new, redesigned housing finance system is fully functioning. During this period of transition, it will be critical to avoid market disruption and to adjust course, when necessary, in response to shifts in the market and other critical events. The goal would be transition, not turbulence.

If I may have just a couple minutes more, Mr. Chairman, the fourth objective is ensuring access to safe and affordable mortgages for all borrowers. This is a core principle for all of us. The housing finance system of the future must be one from which all Americans can benefit on equal terms. The commission believes that access to

the Government-guaranteed secondary market must be open on full and equal terms to lenders of all types, including community banks and credit unions, and in all geographic areas. Again, Ginnie Mae's success in empowering smaller institutions to participate in programs like this is instructive here.

And, finally, the FHA, the Federal Housing Administration, must return to its traditional mission of primarily serving first-time home buyers and borrowers with limited savings for downpayments. The recent concerns over the solvency of FHA's single-family insurance fund only underscore the urgency of what we have—that far more risk-bearing private capital must flow into our Nation's housing finance system. A system in which private capital is plentiful will reduce the pressure that is sometimes placed on the FHA to act as the mortgage credit provider of last resort and allow it to perform its traditional missions more effectively.

Our proposals for reforming the rental, or multifamily, housing finance system are rooted in the same principles as single-family reform: the gradual wind-down of the GSEs; a greater role for capital to enter into the picture with the same catastrophic risk protections by the Government.

Mr. Chairman, our report goes into considerable detail about individual components of the housing finance system that we envision. It describes the structure and responsibilities of the Public Guarantor as well as the roles of the private actors in this system.

We have proposed a bipartisan plan that substantially reduces the Government intervention in the housing market and also protects the taxpayers, while ensuring the broad availability of affordable mortgage credit. I believe it strikes the right balance among competing policy goals and deserves your consideration.

As a final note, the commission report identifies several factors that continue to stall a housing recovery in the immediate term, and those factors include: overly strict lending standards, which now go well beyond those in place before the housing bubble; and put-back risk—that is, the risk that lenders will be required to buy back a delinquent loan from Fannie Mae, Freddie Mac, or the FHA.

While not our primary focus, we believe that these issues must be resolved before the housing market can fully recover.

Mr. Chairman, it is a real pleasure to be back before the Committee, and I look forward from to—while it is much more pleasant to ask questions, I look forward to trying to answer some of your questions.

[Laughter.]

Chairman JOHNSON. Welcome back, Senator.

Mr. Wallison, please proceed.

STATEMENT OF PETER J. WALLISON, ARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

Mr. WALLISON. Thank you very much. Mr. Chairman, Ranking Member Crapo, and Members of the Committee, good morning.

There is no reason that housing, like virtually every other sector of the U.S. economy, cannot be privately financed. A private system will produce a low-cost and a stable market. The consistent failure of Government efforts to finance home ownership—examples are

the collapse of the S&Ls in the late 1980s, and the insolvency of Fannie Mae and Freddie Mac—should make Congress very reluctant to authorize another Government program. Many groups around Washington are suggesting imaginative ways to get the Government back into the housing business while avoiding, they claim, the mistakes of the past.

These proposals are illusory. Government involvement will always result in losses because it always creates moral hazard.

Fannie and Freddie are good examples. Because of their Government backing, no one cared what risks they were taking. That is what moral hazard does.

In 1992, Congress adopted the affordable housing goals. To meet HUD's quotas for low-income loans under these goals, the GSEs had to abandon their traditional focus on prime mortgages and substantially loosen their underwriting standards. By 1995, they were buying mortgages with 3-percent downpayments, and by 2000 they were accepting mortgages with no downpayment at all. By 2008, they were insolvent. This will happen every time the Government backs the housing finance business.

How, then, would a private system work? My colleagues and I at AEI have proposed a simple idea—that the housing finance market will operate steadily and stably if only private mortgages are securitized. Before the affordable housing goals, when the GSEs would only buy prime mortgages, we had such a stable market. Subprime and other low-quality loans were a niche business. We should eliminate the GSEs, of course, but Congress can achieve the same mortgage market stability simply by requiring that only prime loans are securitized. This idea is at the root of the qualified residential mortgage in Dodd-Frank, but very poorly implemented.

Reasonable underwriting standards and prime mortgages will not limit the availability of mortgage credit for those who can afford to carry the cost of a home. When Fannie and Freddie were accepting only prime loans, the home ownership rate in the United States was 64 percent. After the affordable housing goals, the rate went to almost 70 percent. But half of all mortgages in the United States, 28 million loans, were subprime or otherwise weak. When they defaulted in unprecedented numbers in 2007, we had a mortgage meltdown and a financial crisis. We paid a terrible price for that last 5 percent.

Some argue that investors will not buy mortgage-backed securities unless they are Government guaranteed. If it were really true that investors were afraid of credit risk, nothing in our economy would be financed. However, prime mortgages and mortgage-backed securities based on them are not risky investments. Their traditional default rate was well under 1 percent. The natural investors in mortgages are insurance companies, pension funds, and mutual funds. They need long-term assets to match their long-term liabilities.

Today these institutional investors, which, according to the Fed's flow of funds data, have over $21 trillion to invest, do not buy any significant amount of GSE or Ginnie Mae securities. They earn their returns by taking credit risk, and the yields on these securities on which the taxpayers are taking the risk are simply too low.

Institutional investors have told us that if there were a steady flow of mortgage-backed securities on prime mortgages, they would be avid buyers. Securitizers and mortgage insurers have told us that a private system based on prime mortgages with mortgage insurance could finance a fully prepayable, 30-year, fixed-rate loan for about 20 basis points more than Fannie and Freddie are now requiring.

Thus, a private system based on prime mortgages would operate at close to the cost of the current Government-dominated system without involving any risks to the taxpayers. To make such a system possible, the GSEs should be wound down over 5 years by reducing the conforming loan limits, and in light of the devastation caused by the most recent Government intervention in the housing market, this is a chance for Congress to end this very painful cycle of failure.

Thank you.

Chairman JOHNSON. Thank you.

Ms. Ratcliffe, please proceed.

STATEMENT OF JANNEKE RATCLIFFE, SENIOR FELLOW, CENTER FOR AMERICAN PROGRESS ACTION FUND

Ms. RATCLIFFE. Good morning, Chairman Johnson, Ranking Member Crapo, and Members of the Committee. I am Janneke Ratcliffe, and in addition to being a senior fellow at the Center for American Progress Action Fund and with the UNC Center for Community Capital, I am also a member of the Mortgage Finance Working Group.

In 2011, we drafted a "Plan for a Responsible Market for Housing Finance"—and thank you so much for having me here today. While I will present recommendations from that plan, I speak only for myself today.

As the crisis has taught us and our research confirms, many of the benefits arising from housing depend on the way in which housing is financed, and that is precisely the reason why since 1932 the Government has sought to foster a mortgage marketplace that is stable, safe, efficient, and affordable.

A hallmark of Government support is the long-term fixed-rate mortgage. Partly as a result, home ownership has served as a crucial building block of our strong middle class. However, the housing finance system is not functioning so well today, as we have discussed here, at least not for families and communities. It is too hard to get a mortgage, and many of today's renters must spend too much of their income on housing.

Fortunately, there is a bipartisan way forward. The Bipartisan Policy Center's Housing Commission agrees that we urgently need a better system for financing rental housing, and that all creditworthy borrowers should be able to access home ownership. Perhaps most importantly, the commission's plan is one of at least 18 proposals, including other bipartisan proposals and our own, that call for Government support of the core of the market now served by Fannie Mae and Freddie Mac. We see a very broad consensus emerging.

Now, we could continue to discuss Government's role, and meanwhile the Government would continue to take full credit risk on

nearly all mortgages. But I hope that we can also discuss how to structure a role that is safe for taxpayers and good for the economy as well.

Like the Bipartisan Policy Commission plan, our plan seeks to bring in as much private capital as possible. We propose privately run, well-capitalized regulated entities who would take the credit risk function that the GSEs currently have, on mortgage-backed securities only that meet specific standards. These chartered mortgage institutions, or CMIs, would also pay into a Government-managed reinsurance fund. This backstop would be explicit. It would be paid for and well protected by private capital, and that is in stark contrast to the prior GSE situation where the guarantee was ambiguous at best, not paid for, and much too highly leveraged.

Comparing our plans with others highlights key considerations for addressing the important issues you raised in your invitation to speak today. First, broad availability of the long-term fixed-rate mortgage depends on a Government guarantee. Without it—many analysts have confirmed this—the 30-year fixed-rate mortgage is likely to be much less widely available and more expensive.

Second, equal access for smaller lenders and those serving smaller communities is one feature of the current system that should be retained and built on. We warn against putting small originators at the mercy of their large competitors for access to the Government guarantee and against concentrating credit risk with big banks. In our proposal, originating lenders would not be allowed to operate a CMI.

Third, the system should provide access for all qualified borrowers and market segments rather than serving only higher-income portions of that market. We propose anti-creaming measures alongside a market access fund that would foster innovation and access safely.

Fourth, funding rental housing. This has been neglected by many plans. We applaud the attention paid by the commission to the crisis in affordable rental housing. Our plan envisions that Government-supported liquidity for multifamily lending would also include some income targeting.

And then, fifth, protecting taxpayers. Serving the Nation's housing needs requires Federal support yes, but only in a limited role that is well buffered by private capital and paid for, as we have discussed.

Finally, economic recovery and stability of the housing market. Spelling out a clear plan with a flexible approach to transition can give the market needed certainty and limit disruptions in the near term. We must also keep our eye on long-term stability. Reliance on private capital does inherently introduce volatility. We, therefore, recommend building in countercyclical measures to maintain liquidity in times of economic stress when private capital tends to flee, as well as measures that impose risk management discipline in good times, as Mr. Wallison's plan points out.

In any event, the future state should prioritize what is in the best interest of the overall economy over the long run. What is at stake is the future of home ownership and economic opportunity for generations to come. These decisions should not be left to a conservator with a substantively different mandate. You now have the op-

portunity to build a mortgage market that is fair, accessible, affordable, and fiscally sound that works better for more households and communities than ever before.

I look forward to your questions.

Chairman JOHNSON. Thank you. Thank you all for your testimony.

As we begin questions, I would ask the clerk to put 5 minutes on the clock.

Senator Martinez, the BPC's report states that continued Government involvement is essential to ensuring that mortgages remain available and affordable to qualified home buyers. Did the commission investigate what would happen to the cost of mortgages for the majority of American families if a Government guarantee did not exist? If so, what did the commission conclude?

Mr. MARTINEZ. Mr. Chairman, the commission addressed that issue, and let me say that I come at the conclusions that we reach, particularly on the Government backstop, as one who fundamentally began learning about the GSEs by listening to Peter Wallison's warnings that their system was fatally flawed. And it was. And so I am one that is very reluctant, because I was a great advocate of better regulatory and governance, if at all, with the GSEs for a long, long time, as HUD Secretary and then as a Senator, very reluctant to embrace any sort of a Government involvement in the system.

However, I think the judgment was made by the commission that a 30-year mortgage was a desirable goal for the American people and something that is kind of embedded into our housing finance system and expectations that we have. Not all of the world enjoys a fixed-rate, 30-year, low-cost mortgage. So we are unique in that. And part of that uniqueness, we came to the conclusion, resides in having some form of a Government backstop ultimately.

While there may be a market for mortgage-backed securities that are purely private label, unquestionably there are places like central banks in distant lands and a whole lot of foreign investors as well as other domestic investors who just simply will not buy a mortgage-backed security that does not have some sort of Government backstop.

So the way we approached it is to put the Government in the most protected position we could put the Government and in the most limited way possible with a funded fund. And the idea was to simply have three layers before you ever get to the Government and the creation of a credit enhancer in between that would be well capitalized, well regulated, and that would provide the real backstop at any point unless there was just this cataclysmic, catastrophic sort of event.

Chairman JOHNSON. Senator Martinez, a BPC report seems to recommend a Government backstop with powers similar to Ginnie Mae and the FDIC. Is that accurate?

Mr. MARTINEZ. That is correct, Mr. Chairman, and the thing we want to make sure we would not do is in any way replicate the model that was so fatally flawed in Fannie and Freddie. So that is correct. It is a Ginnie Mae-based model.

Chairman JOHNSON. In that model, would the Government guarantor have exam and enforcement authority over the private enti-

ties standing in front of the Government guarantee in the primary and secondary market?

Mr. MARTINEZ. That is correct, sir.

Chairman JOHNSON. Senator Martinez and Ms. Ratcliffe, both of your respective plans recommend a Government backstop, but the plans differ when they come to how loans are securitized. Under your respective plans, how would small community banks and credit unions access the secondary market? Senator Martinez, let us start with you.

Mr. MARTINEZ. Well, Senator, we made clear that our system was one that would be designed similar to Ginnie Mae, and in that regard, that it would be open to community banks, it would be open to credit unions, and it would be open to the small players in the marketplace. And we feel like that is a very important component not only for the liquidity that it brings about but also because it is just a fair system that allows all players to play an equally important role.

Chairman JOHNSON. Ms. Ratcliffe?

Ms. RATCLIFFE. Thank you. We are completely in agreement——

Chairman JOHNSON. Turn on your mic.

Ms. RATCLIFFE. Thank you. We are completely in agreement that the ability of small banks and banks in small communities, to be able to offer the same kinds of products that are equally priced and transparent and well understood, that has to be maintained in the system going forward. And that is a function that Fannie and Freddie largely have allowed to happen.

There are some ways in which our plan differs technically from the BPC plan, but we also looked to the Ginnie Mae model where very small issuers can put out pools of loans.

The difference in our case is that, instead of the issuer being responsible for obtaining the credit enhancement, the first loss credit enhancement, it would be left to specialized institutions that would be providing that function only and not doing the issuing. So that is the difference. And we feel that that would enable smaller institutions to be able to access that kind of guarantee on the same terms as large institutions.

Chairman JOHNSON. Ms. Ratcliffe, I am very concerned that low- and middle-income families in rural areas might be ignored by private capital. Based on your research, are these fears valid? And what underwriting requirements should a new system include to ensure families have access to affordable mortgages while also protecting taxpayers?

Ms. RATCLIFFE. Yes, sir. I think that is a legitimate concern. The market does tend to provide the best products to the parts of the market where it is easiest to do so, and that tends to be more affluent borrowers, and so they can tend to cherrypick or cream and leave out large segments, particularly lower-wealth borrowers, lower-income borrowers, borrowers in less well resourced communities.

We have lots of evidence that shows that lending to these kinds of families can be done safely and soundly. Case in point: For the last 10 years, we have been studying a portfolio of almost 50,000 loans made to borrowers by banks around the country. The median borrower earned $35,000 a year. Most of the borrowers put down

less than 5 percent, and half of them had credit scores below 680. Today they would not be able to get mortgages, and yet even through the crisis, they have managed to perform pretty well. And it is a sign that, when provided safe and sound products, like the 30-year fixed-rate mortgage, and well underwritten and given access to the mainstream prime market, you can make safe and sound mortgages.

So we think it is very important not to let these segments go underserved. It is very important to the rest of the market. It is the first step of home ownership that allows other people to move up and sell their homes and so on and so forth. So it is a critical function of a well-functioning market to see that that market gets served.

That does lead us to how you do it, and our plan has an extensive discussion. We agree with many other people that the affordable housing goals that Fannie and Freddie were subject to were not the right way to go about achieving this. They were blunt instruments and, frankly, not that effective. And so in our plan we talk about a more plan-based strategic approach to ensuring that this access is provided. And in addition to having a sort of duty to serve on these entities, we would offer tools that could help make that possible, such as a market access fund, which could provide a safe and sound way for institutions to try research and development and find new ways to expand the market safely.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman. I want to start out, I hope briefly, with the question that I raised in my opening commission relating to Congress' tinkering with the guarantee fees.

As I indicated in my opening comments, I have my opposition and there is bipartisan opposition on this Committee to using an increase in the guarantee fees to offset, in one case, tax cuts and, in the current proposal in the budget, spending increases.

Do any of you believe that we ought to be offsetting Government spending, which may or may not even be related to housing policy, through increases in the guarantee fees charged by Fannie Mae and Freddie Mac?

Mr. MARTINEZ. I clearly do not, sir, and I applaud the bipartisan bill that has been offered.

Senator CRAPO. Thank you.

Mr. Wallison?

Mr. WALLISON. I am of the same view. I think it would be a big mistake to get the GSEs involved in paying for other aspects of the Government's activities.

Senator CRAPO. Ms. Ratcliffe?

Ms. RATCLIFFE. I see that we have bipartisan consensus here, and I would agree. And I would suggest that we also be thinking about constructive ways that surplus g-fees could be used in some ways to start capitalizing for a new system of the future as well as thinking about the Housing Trust Fund and the Capital Magnet Fund that have still gone unfunded.

Senator CRAPO. Well, thank you, and I would like all of you to respond to this. I am going to start with Mr. Wallison, but the next question I want to get into is how we correctly price risk and

whether there really is a consumer benefit if we correctly price risk.

I think one thing we have learned is the Government is not very good at pricing risk, but some experts have suggested that if we assume the Federal Government was able to accurately price risk and actually charged fees that are high enough to fully offset that risk, then the pricing benefit that is traditionally associated with a Government guarantee would disappear. Instead, the Government would have to charge as much or nearly as much as the private sector would to assume this risk, and, thus, the only way to achieve lower pricing through Government guarantees would be by having the taxpayers subsidize risk.

Could you comment on this point, Mr. Wallison?

Mr. WALLISON. Yes. I do not think there is any evidence that the Government can effectively price for risk. There are several reasons for this. One is that the Government does not have the incentive that insurance companies have to price for risk. Another is that to protect against catastrophic events it is necessary to build up a fund. What we find all the time is that once the fund is created, the interests come in and argue that the fund is large enough, we do not have to charge any more, and Congress agrees. As a result, the fund never gets to the size that it should in order to deal with the catastrophes that eventually occur.

We can see that, of course, because the Government just had to bail out the Flood Insurance Program because there was not enough money in that fund. That was an insurance fund. The FDIC was insolvent for a period of time after 2008 because it had not built a big enough fund.

It will again be a mistake if we set up another fund. We will find, 10 years from now, when we have a problem, that the fund was not adequately funded.

Senator CRAPO. Thank you.

Ms. Ratcliffe, do you have an opinion on this?

Ms. RATCLIFFE. Yes. First of all, we also have some evidence that the private sector has some problems pricing risk, so I do not think it is an either/or thing.

To Peter's point—and the commission's proposal and our proposal both use the mechanism of putting private capital at risk, in our case private entities whose capital would have to be fully depleted before the backstop—first, the fund would be hit and then depleted before a backstop. So clearly this puts the onus on the private sector entities to figure out the right risk pricing.

In contrast to the GSEs, you know, they had to hold 45 basis points of capital on the risk, and the commission's plan and ours are similarly recognizing that, you know, the recent crisis gives us a pretty good idea of the high watermark that we need to be thinking about. Maybe it is a 4 to 5 percent kind of capitalization requirement. That would be many times higher than what the GSEs were carrying.

So I think if you can put private entities in a meaningful first loss position that is not too highly leveraged, then you will have the combination, the best combination, of private sector discipline and public sector oversight.

Senator CRAPO. Mr. Martinez?

Mr. MARTINEZ. We largely agree, particularly with the last comments Ms. Ratcliffe made, and I believe particularly in the sense that we are looking to well capitalize credit enhances that would be well regulated and well capitalized all along, putting the Government in the very last position.

So, to me, I view—by the way, the FDIC is a good model as well. While they may have had a hiccup around 2008 when a lot of things were not going to exactly right, it ultimately righted its own ship. And I believe that the FDIC is a model that can be replicated in terms of funding a fund that will ultimately be there.

One other thing that has not been touched on and I think is very important that we discuss in terms of the Government guarantor is the necessity for there to be a TBA market. The to-be-announced market is an essential ingredient of secondary mortgage markets, and without a Government guarantor, the TBA market would not exist. And I think before we think that it can be dispensed with, we should give a very close look to the importance of the TBA market and the importance the TBA market has in creating the kinds of liquidity and fungibility that mortgages have today that allows them to be traded forward.

Senator CRAPO. Thank you.

Chairman JOHNSON. Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman. Thank you, panel, for your excellent testimony. And welcome back, Mr. Secretary. Good to see you.

As the author of the National Housing Trust Fund and the Capital Magnet Fund, I was very pleased to see that your Housing Commission recommended retention of these two entities in a reformed housing system. Can you comment upon the basis of your recommendation and why we need to maintain these programs?

Mr. MARTINEZ. Well, Senator, I think that there was a recognition that these programs, although still in——

Senator REED. Infancy.

Mr. MARTINEZ. In the infancy, correct—were an important way in which, you know, we can create affordability and create accessibility to those that otherwise might not have it. And so there was not a lot of dissension in terms of that. I mean, obviously some would differ, but I think the consensus of the group was that it should be maintained and it should be left as it is.

Senator REED. Thank you very much, Mr. Secretary, and, again, thank you for your service both here and over at HUD. Thank you very much.

Mr. MARTINEZ. Thank you.

Senator REED. Ms. Ratcliffe, I was pleased to see that in your comments you mentioned rental housing, because one of the perceptions is this is just about home ownership and that our housing goals have to embrace that. But you also indicate that we have to have responsible plans for financing affordable rental properties.

Could you elaborate upon that? Again, I think one of the conclusions coming out of the last several years is that rental housing is for some people the best choice, not just the default choice. If you would comment?

Ms. RATCLIFFE. Sure. Right, I agree that we really cannot get on track without a strong rental housing finance system. More than

a third of Americans live in rental housing, and more than half of them spend more than 30 percent of their income on housing, which is a much higher share than of homeowners' spending that much of their income on housing.

There has been a sharp drop in construction of multifamily rental residences, but it is quite—everybody projects an increase in the demand for rentals. So we only see this pressure on rental rates rising.

Providing long-term, efficient, affordable capital for rental housing also results in long-term affordable, stable rental rates. And so we see the direct connection between the secondary market system for the multifamily market to that kind of stability for renters.

Stability in housing and affordability in housing for renters is a way that they can start to create some space between their income and their monthly payment, that they can start building some assets and some economic stability. So we think it is critical that the system take that into account. And in some ways, you know, for renters, renting might be an option for now, but having that kind of stable rental where you can start to build some savings is also in a sense the first step on the ladder to home ownership.

Senator REED. One of the other phenomena that we are beginning to recognize now is that there is a whole cohort, a whole generation of Americans that have extraordinary debt from their college education, from postsecondary education. In fact, the Pew report I think just last week indicated this could defer home purchases for several years from 25 to 35, which does several things: one, it impacts home ownership, which you are struggling with, that issue; but also I think it underscores the need, again, for rental housing, because there are going to be many young families who 20 years ago would have had the downpayment, bought the house, *et cetera,* and now are going to be waiting 10 years as they pay off their college loans, and they will need rental housing. Is that another factor that we have to consider?

Ms. RATCLIFFE. Absolutely. Yes, sir, we do. And I think just looking generally ahead at the demographic trends, the home buyers of the future or, for that matter, the renters of the future, the source of housing demand in the future is going to come from households that are less wealthy, younger, more likely to be households of color. So we need to be sure that our system serves that segment of the market.

Senator REED. It goes back to this issue of affordability and not just, you know, having the market mechanisms in place.

Mr. Secretary, do you have a comment?

Mr. MARTINEZ. Yes, I just want to add to that. Anecdotally, you can also in the marketplace see that there is just not a lot of available, much less affordable, rental housing today. And I wanted to also add the elderly into the mix, which is a real difficult problem. Affordable housing for the elderly, and adequate housing, and aging in place and all of those things continue to be, I think, a tremendously important issue that we cannot overlook.

Senator REED. Just a quick question. I am sorry, Mr. Wallison. Your testimony is always extremely thoughtful. There are two issues if we go—and this is very conceptual—into an exclusively private market. One of the problems, I think, we saw in 2008 and

2009 was very poor underwriting. And then when you get to the securitization market, credit rating agencies, they could not perform properly.

Is the basis of one of your assumptions going forward with an essentially purely private model that these underwriting problems, which were notorious at Countrywide and other places, can be corrected, will be corrected? And does that imply much greater oversight by regulators like OCC and other Federal regulators and the underwriting process and also dealing with the credit rating agencies?

Mr. WALLISON. Well, first of all, the reason that we had poor underwriting in those periods—and it is not just 2008 and 2009, but actually, again, in the mid-1990s—was because Fannie Mae and Freddie Mac were striving to meet the quotas that HUD was establishing for them under the affordable housing goals.

Senator REED. But excuse me. Countrywide was being forced to write terrible loans even as their market share grew much more dramatically than Fannie Mae because of the affordable housing goals.

Mr. WALLISON. Sure, but how——

Senator REED. They were not subject to those goals.

Mr. WALLISON. Right, they were not partly responsible. But they had a buyer in Fannie Mae and Freddie Mac. They were the biggest suppliers to Fannie Mae. And the reason they created all those terrible loans was because Fannie Mae and Freddie Mac wanted them.

We cannot just look at the originators. We should look at the customers that they had, and the customers were in the Government.

Senator REED. Well, what about private securitizations of Wall Street which became hugely important, which did not have affordable housing goals, which essentially were going to Countrywide and saying, "You do not need Fannie and Freddie, you got us and we got you, and we got the credit rating agencies"? They were not at all a problem?

Mr. WALLISON. I agree that the private sector was also guilty here.

Senator REED. Well, thank you.

Mr. WALLISON. I am not saying the private sector was not partly responsible. But if you look at where those bad mortgages went, 74 percent of them were on the books of the Government agencies in 2008; 26 percent were on the books of private agencies, private organizations. So the main malefactor in our problems in 2008 was the Government.

Senator REED. By 2008, 6.2 percent of these GSE mortgages—I think you were talking about it—were seriously delinquent versus 28.3 percent of non-GSE securitized mortgages. So where did the bad mortgages go? To Fannie or to the private Wall Street crowd?

Mr. WALLISON. With all respect, Senator, Fannie became insolvent, and so did Freddie. And the reason they became insolvent——

Senator REED. And Countrywide did, and——

Mr. WALLISON.——was because they acquired so many terrible mortgages.

Senator REED. And Countrywide did, and many others did, and one could argue that some of the major financial institutions in the United States would have been insolvent except for being bailed out by the Fed.

Thank you.

Chairman JOHNSON. Senator Martinez.

Mr. MARTINEZ. You mean Menendez.

[Laughter.]

Senator REED. No comment.

Senator MENENDEZ. We are both Cuban, Mr. Chairman, but he is better looking than I am.

[Laughter.]

Senator MENENDEZ. Let me thank you all for your testimony. You know, the one thing I hear pretty universally—maybe different views exactly, but there has to be some Government backstop here, or else the market as we know it, particularly for the aspirations of typical families would not be realized at the end of the day.

I would like to ask you, Ms. Ratcliffe, there are nearly 12 million Government-sponsored borrowers who are current on their loans, but they are underwater and they cannot refinance under today's lower mortgage rates. Both I and Senator Boxer have introduced legislation that would help these hard-working families to lower their payments and, in doing so, continue to be responsible borrowers, solidify a part of the housing market, and in my view, also unlock some economic potential because if I have the roof and it has been leaking and I cannot afford to replace it and I now have an additional $300 or $400 in my cash-flow because I have reduced my mortgage payments, I can replace the roof. That means I am going to hire somebody. That means it is going to have a ripple effect in the economy.

What are your thoughts on the outcome of such legislation might be on the current market?

Ms. RATCLIFFE. So, generally, we are supportive of principal reduction when it can be a win-win-win situation for the borrower and the investor and the community that they are in. Early research that we did has demonstrated that default rates and recoveries on loans where a principal reduction is granted are much more favorable than when you go ahead with the foreclosure. And it still escapes me why servicers are so eager to go ahead with short sales and other situations where they get back less for the sale of their property than when a principal reduction to the current owner might actually achieve a better economic outcome. So we have generally supported principal reduction where it can be——

Senator MENENDEZ. And I appreciate that. In our case, what we are just simply saying is let us remove the barriers to refinancing on the historically lower rates right now——

Ms. RATCLIFFE. And, absolutely, that even goes without saying, even further. The debt loads that people are carrying right now on their housing is one of the things that is holding back the housing recovery. So if you can alleviate that, I think it would be good for the economy.

Senator MENENDEZ. Let me ask Senator Martinez: The Coalition for Sensible Lending recently presented to Congress its findings on

what the credit space would look like for first-time home buyers and minority families if the QRM rule incorporated even a 10-percent downpayment. The results were not encouraging considering that the average time for a medium-income African American family to save 10 percent on a medium-priced home was 31 years and 20 years for a comparable white family.

What does this mean for discussions on limiting the Government's role or using a 20-percent downpayment as the gold standard?

Mr. MARTINEZ. Senator, I think it would be very, very difficult to have a viable opportunity for home ownership for a whole lot of Americans, and I am thinking that a 20 percent goal would be really—it would just put way too many Americans out of the dream of home ownership.

So in a responsibly actuarial way, with good underwriting, you know, verifying employment, and a whole lot of other things that ought to go into it that at some time in the recent past were abandoned, I think there still should be a place for there to be a low loan-to-value sort of mortgage for families that are struggling to reach the American dream.

Senator MENENDEZ. And I think that you hit the nail on the head when you said looking at the variety of factors to consider in terms of risk and underwriting is incredibly important as well, not just a position on which you say 20 percent.

Ms. Ratcliffe, in a countercyclical time, when private capital retreats from the market without a vehicle to provide mortgage credit, how would American families buy a home? And would that not have a profoundly negative effect on the economy in terms of recovery?

Ms. RATCLIFFE. You raise a very challenging question for GSE reform, for the issues that lay ahead of you today.

In our proposal, we would suggest—you know, the GSEs currently have this or used to have this portfolio function that they used a lot of times to address countercyclicality, and we do not call for that function to be continued in the reformed secondary market.

We propose a mechanism where perhaps a special class of debt could be issued in times of crisis that would maybe move around a little bit the relationship between the Federal role and—the Government role and the private role of the fund and the private capital to keep a reliable flow of credit going in tough times.

But I also wanted to come back to the point that what happens in tough times is largely a function of what you have allowed to happen as well in good times. If in times of strong markets, capital requirements are reduced, underwriting standards are loosened too much, you are basically setting up the failure during the tougher times.

So it is very important to maintain strong capitalization of any risk-taking entities and strong risk management disciplines, and we see that this can be done if you establish specialized monoline entities to take that risk that are well regulated and well capitalized and well monitored, and that actually buildup capital in good times. So it is countercyclical in the good times as well as in the difficult times.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Menendez.

Senator Corker?

Senator CORKER. Thank you, Mr. Chairman. I am out of breath.

I welcome all of you, and certainly I always enjoy having a bipartisan, sort of the to right/sort of to the left presentation on something that is very complicated. I want to thank each of you for your—sorry.

[Laughter.]

Senator CORKER.——for your support of the bill to at least begin making sure that g-fees are not being used to pay for other things and that we have the ability to know that, you know, we are going to do something different with the GSEs.

The GSEs both—I am going to make more of a statement than ask a question, but the GSEs have been a political football for both sides for years. And each side has had a lot of fun with this political football. Certainly during Dodd-Frank, I know folks on our side did, and now we have an opportunity, I think, and I think the environment is right to actually do something very good, and I applaud all three of you for coming in and talking with us. And I certainly appreciate what each of you have done through the years to sort of help us think through this.

I sort of feel the environment is getting right, and Ed DeMarco, who is at FHFA—you know, certainly I know some of my friends on the other side of the aisle have some issues with him, but as a technocrat, he has been pretty good at sort of laying—I see each of you nodding your head up and down, for the record. He has been pretty good.

[Laughter.]

Senator CORKER. He has been pretty good at the technical issues of walking through. I know that some of my friends do not like some of the policy decisions that he ha made, but even on those, it looks like he is coming around a little bit to their way of thinking on some things.

But, regardless, my point is that the GSEs are very complex. Numbers of us have sat down in bipartisan meetings to walk through the things that have to be dealt with on the GSEs. It is very complex. It requires a lot of things to work together, so walking through a transition to a reformed situation is going to be very difficult.

The Administration recently has floated a name through the press of a person to lead the GSEs, and let me just mention, you know, I am Ranking Member on Foreign Relations. We had almost a unanimous vote for a politician to lead the State Department. We have a politician leading Defense. And I am all for politicians going on to grander things. But I think the GSEs are a very unusual situation, and that is that we really need somebody with technical strength and with no political bias whatsoever to help us walk through this. And the last thing that we need is a politician that has actually been involved in these issues for years leading the organization.

And I would just ask you, if you agree, that regardless of whose technocrat it is, that between now and the actual implementation of a changed program we would be better off having a technocrat at the head—it can be the Democrats' technocrat or the Repub-

licans' technocrat, but somebody that actually understands these issues and knows that he is going to have to walk through the reform process fully, and if it is not done with tremendous grace, it could do a lot of damage to an industry that is very important to our country.

You can answer that yes/no.

[Laughter.]

Mr. MARTINEZ. Senator, I think you are pretty accurate. I mean, I agree with you. I think it ought to be a very technical person, and I also agree that Ed DeMarco has done a great deal of—a great public service in his role, and I think someone that emulates his sort of nonpolitical role, who is well rooted in the intricacies of these very complicated entities, would be the ideal person.

Mr. WALLISON. Yes, I would agree, Senator Corker. Ed DeMarco has been a remarkable public servant. One of the things that he has done is he has begun a process of preparing the GSEs for either some sort of Government program or a private program without siding with either of those. And he has also helped a little bit to make it possible for the private sector to compete with the GSEs by raising the g-fees.

So we need another person like Ed DeMarco, if not Ed DeMarco himself.

Ms. RATCLIFFE. So I think that depends somewhat on the extent to which the candidate understands the mortgage finance system and the intricacies and complexities that you described. And, of course, if they are from North Carolina, that would be a factor in my decision.

[Laughter.]

Ms. RATCLIFFE. But, seriously, I think the important thing about reform is not so much who is in the conservator's seat with a conservator's mandate, but the necessity of this body to come up with a plan for reform of the secondary market.

Senator CORKER. I agree. And I think that, I mean, when you start going through the nuances of this, what really is going to happen—Mark Warner and I had a great meeting yesterday with someone to walk through—you are going to really end up depending upon that conservator. You cannot lay out every detail, and we saw that—I mean, my friends on the other side of the aisle understood that during Dodd-Frank. You cannot lay out every detail. You have got to leave it up to the regulators to have some discretion.

Well, certainly, as we transition from where we are today to a new system, you are going to have to leave some of the guidelines somewhat broad so that there is discretion.

So, again, I think making sure that we continue to have a neutral figure, if you will, one that is trusted, regardless of who it is, and has the ability to walk through the technical issues to me would be very important.

I know my time is up. I thank you each. I know we have had multiple conversations. I look forward to more. And I do think—I hope, Mr. Chairman, that 2013 will not end without us doing something in a bipartisan way to reform these. I really do think that is possible, and I hope the Chairman and Ranking Member will decide to let that happen. So thank you.

Chairman JOHNSON. Thank you.

Senator Tester.

Senator TESTER. Yes, thank you, Mr. Chairman. And before I start with my questions, as long as Senator Corker is here, he is spot on, and I think Ms. Ratcliffe is spot on, along with the rest of you. We really need to tackle this problem, and I think the time is right. I think we played political football while the industries are out there looking at us and saying, “Why don’t you get after it and get it done?” And we will end up with something that not everybody is entirely happy with, but a hell of a lot better than we have now.

And so I think that is really the crux of it, and that is why I really thank you guys for your testimony. And there was a lot of agreement up here, whether it is from the left or the right or the center, or wherever, on where we need to go.

I am going to start out with you, Senator Martinez, and I want to thank you and the Bipartisan Policy Commission for specifically outlining the importance of housing in rural communities. And as the commission acknowledged, rural communities are home to about one-third of the U.S. population. They face unique challenges, which can include a dearth of quality housing and a significant number of household spending a substantial portion of their income on housing costs.

And I also appreciate that you have explored the issue of rental housing. Critically important, I think it is absolutely important, especially in rural America, but maybe all over the country, and I think you have advocated USDA’s role in supporting rural households.

There is another issue that I was wondering whether you looked into or not. It is an issue that, quite frankly, my wife and I dealt with 20 years ago when we built a house. We could have rehabbed our old one, but it made more sense and it was more cost-effective just to start over. That is not true in all cases. Sometimes rehabbing a house is much better, much more cost-efficient.

Did you look into whether there might be opportunities to finance rehabilitation as a more efficient way to improve particularly rural housing stock?

Mr. MARTINEZ. No, Senator, we did not really look at that. It is not an area that we delved into at all.

Senator TESTER. Well, let me ask any of the panelists up there. Is this something that you think has merit, or should we stay away from it? And what I am talking about is rehabbing versus rebuilding.

Ms. RATCLIFFE. Not only in the context of rural housing, if I may, but also in the context of community revitalization, clearly the role of—a need, a shortage of good financing for acquisition rehab, for example, has been identified, and so I would agree with you.

And in terms of rural housing more generally, something else I would point to is HERA called for the GSE conservator to set “duty to serve” requirements on rural housing, manufactured housing, and affordable housing preservation, which touch on a number of issues for rural communities. And the idea behind this would be instead of having, you know, numeric goals, like the housing goals, there would be more of a strategic comprehensive plan that would lay out what the agencies would be expected to do to try to expand

service to those markets. And those three subsets were identified as places where there is big financing gaps.

And so I believe there is a proposed rule on that, but it has not been finalized yet.

Senator TESTER. OK. We will talk about smaller financial institutions. It has been talked about a lot already, and many of the questions have been answered. But particularly for Senator Martinez and Ms. Ratcliffe, in developing your plans, was there any analysis of the role smaller financial institutions play currently in the housing finance system and what impact a system that limited the access of these firms to the secondary market would have on mortgage costs and access to mortgage products in rural America?

Mr. MARTINEZ. There is no question, Senator, that that was an important consideration. We felt that access for the smaller institutions into the secondary market was an essential ingredient, not only the community banks but also the credit unions. And it was something that we emphasized in our report. And I should also add that Senator Kit Bond, who is a great advocate of rural housing, a former colleague of ours, you know, his role on the commission was a great champion of the whole rural housing in small communities and the community enterprises as well to be participants in the marketplace.

Senator TESTER. Ms. Ratcliffe, do you have anything to add to that?

Ms. RATCLIFFE. I mean, I would agree completely. I would just—as a case study, I described the program we have been studying for the last 10 years with the 50,000 mortgages that were originated by banks around the country, and a lot of these banks were doing this to meet the needs of their local communities as they identified them. But without a way to sell those mortgages into the secondary market, it really limited their ability to provide that financing.

So what this program did was it created a partnership with Fannie Mae to be able to sell these loans to the GSEs, and that enabled those institutions to provide that kind of financing at the level that their communities need it.

Senator TESTER. Well, thank you, and I want to once again thank you all. And I also want to, as long as the Ranking Member is here with the Chairman, say how important I think this issue is. I talked in my opening remarks about how the housing market is coming back, and I think it is doing it in spite of us. And I think that if we were able to sit down and make this a priority for this Congress to get this through and get bipartisan support for a bill that will deal with the GSEs, I think it would be something we could all be proud of on this Committee and something whose time has come and passed, and so we need to deal with it.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. Let me take off where my friend Senator Tester left off and simply echo his views that, you know, I really do think this is the moment. There were clearly concerns about kind of the "do no harm" over the last few years. The housing market was slowly recovering. I have the fear that, as the housing market now may be recovering very quickly, we are going to see enormous profits starting to flow back into

Fannie and Freddie and the pressure to—you know, there is going to be this normal—well, let us just go back to the status quo, and maybe this is not a problem. And I think there are real challenges in this system that we have got right now, and that there is actually a lot more bipartisan accord than on many of the other issues.

I would also say that one of the things that we have been looking at that I do not know, Senator Martinez—and it is great to see this panel back here again—whether you all looked at that there are certain almost utility-like functions that actually FHFA is trying to move forward with now and trying to bring more transparency around common standards in terms of appraisals, underwriting, you know, a single-securitization platform.

There is a utility component in all of this that even my good friend Peter Wallison might say needs to be not done by a private sector entity but a utility function here. Did you look at all at that issue?

Mr. MARTINEZ. Well, Senator, in the Government guarantor, as we call it, there would be regulatory functions, there would be—those kinds of functions would reside there without creating anything akin to the current models of the GSEs. But there would be some functions in terms of ensuring that the private sector actors were well capitalized, you know, the kinds of functions that I think you would expect there to be.

Senator WARNER. I actually believe there may be something earlier on in the chain where there might be this kind of common information transparency platform that would be totally separate from any kind of Government backstop that currently Fannie and Freddie perform, but not very well. But it all starts, again, with a basis around transparency.

Let me hit a couple other points. I have got a lot, unless we are going to get a second round.

I do believe, as I think at least two out of the three panelists agree, that if we put enough tranches in front of any Government backstop, you know, home equity, mortgage insurance, risk reserves, a catastrophic FDIC-type fund, and then if all of that—an FDIC-type fund that would then be replenished from the industry, but there could still be some ultimate backstop during the moment of crisis.

Now, I have spent a lot of time and have enormous respect for Peter Wallison in terms of our discussions, and, you know, I know never, ever, ever Government backstop anywhere messes up things. Here is my—here is my question to you:

If we had—and just envision this as a potential; I want to hear all of you—but this Government backstop at some point, could you not, if that Government backstop, say, took 95 percent of the risk, even within that Government backstop, sell off some small slice, some small sliver, 2 to 5 percent of a private part of that reinsurance, that could be that kind of private market warning system if everything along the way was sliding into too much complacency.

Do you want to start? And then if the others——

Mr. WALLISON. I think it is possible to do something like that. I have not seen it done, but I think it is possible.

I would like to say this, though, about these private backstops: The problem with them is that the idea is to protect the buyer of

the mortgage-backed security. Once you have protected the buyer of the mortgage-backed security, that person is not worried anymore about the risks that are in the system, not worried about the quality of the mortgages, not worried about the capital of the issuer of that mortgage, or mortgage-backed security. And so you eliminate any kind of market discipline at that point.

Now, the BPC plan and I think the other plan from CAP that we were talking about kind of assume that the Government is going to step in, and everyone in the industry will probably believe that, too. The people who are in mortgage insurers, the people who are the various corporations that are issuing these mortgages or mortgage-backed securities, will all assume that they are going to be bailed out if something happens in the market. And as a result of that, there will not be any kind of market discipline on any of them. We will end up with exactly the same process that we had with Fannie Mae and Freddie Mac.

Senator WARNER. Well, I am never going to get you to yes, but I am going to—I would love to sit with you with these various layers, and there may be a way on that ultimate backstop to take a slice.

I know my time has expired. I just want to make one last comment. One of the things that I know at least, Senator Martinez and Ms. Ratcliffe, you have talked about is taking away—on the affordable housing piece, taking it away from this mixed kind of implied effort inside Fannie and Freddie. The question is: If we are going to do it within a housing trust or some other entity, how will we fund that? And how do we make it clear—and my time has expired, and maybe on a second round I can get your thoughts on that.

Ms. RATCLIFFE. Well——

Senator WARNER. I have gone over.

Chairman JOHNSON. We will have a second round.

Senator Warren?

Senator WARREN. Thank you very much, Mr. Chairman, Ranking Member Crapo. Thank you all for being here today.

We take up three issues today that all deal with certainty in the market and how we repair the markets that were so badly broken and demonstrated in this huge financial crisis. Obviously, with GSE reform, I very much agree with Senator Crapo and many of my colleagues, the urgency of the moment, we have got to get this resolved, and we have got to get it resolved now, and I think that is what—the bipartisan bill is a first step toward that.

Also the nomination of Mary Jo White, if you listened to the hearing, was very much about the importance of getting the rules in place going forward in response to what we discovered was wrong during the financial crisis.

The CFPB nomination is also the same. This is an agency that was designed to deal with the fact that the consumer credit market was not working and people were getting cheated. We now have a nominee whom I believe everyone has described as balanced and effective, and yet despite the fact that I think he deserves an up-or-down vote, what has happened is we have no vote on him, we cannot get somebody confirmed, and the consequence of that is to produce uncertainty in the market, which just seems to me to head in the wrong direction. We need a strong, effective consumer agen-

cy. We need an honest consumer credit market, and that happens when we get a Director confirmed.

You know, going forward on GSE reforms, I want to hit a couple of things we have not talked about because I think they are important. One of them is the role of complex financial agreements. We discovered, for example, in the consumer market that agreements about mortgage servicers were so loaded with fine print, lots of tricks, lots of variations on how they would be compensated, for example, that they left open the opportunity for misrepresentations, for deceptions, for outright fraud. And now the consumer agency has come up with uniform servicing agreements to try to deal with that and get an honest market where everybody knows what they are dealing with. You master the one agreement, you have got it.

The question I have is about securitization agreements. Securitization agreements—I actually looked at some of those things—are complicated, very difficult to read and understand and to evaluate the risks associated with transactions there and I think the evidence shows left open the opportunity for misrepresentations, for deception, and for outright fraud.

So the question I want to ask is: Would you support having a standardized security agreement? We will just go down the line. Ms. Ratcliffe, you are closest to me, so you can start.

Ms. RATCLIFFE. Yes, I do. And may I——

Senator WARREN. Please, sure.

Ms. RATCLIFFE. I mean, I do think——

Senator WARREN. When you are saying yes, you get to go longer, yes.

[Laughter.]

Ms. RATCLIFFE. The model, to your point about creating infrastructure and standards and transparency that should apply to all participants in the market, you know, when accessing the standard mainstream Fannie/Freddie market of old, you know, as a borrower, all I had to do was, you know, back in the day, look in the newspaper, and I knew what I was getting, and I was able to see. And by the same token, investors on the other end of that transaction knew exactly what they were getting, and so obviously there is a model to be learned from.

Senator WARREN. Very good explanation. Thank you, Ms. Ratcliffe.

Mr. Wallison?

Mr. WALLISON. Yes, I would agree that it would be a good idea to have a standardized kind of securitization agreement. They are enormously complicated, so it is not the sort of thing that Congress can legislate. But if you get the lawyers together who do these things and you have commentary on the pattern that is adopted, I think it might be worthwhile.

Senator WARREN. Good. That is very helpful. Thank you.

Senator Martinez?

Mr. MARTINEZ. Senator, we did not consider that issue as part of our commission report, but it strikes me as a very good idea.

Senator WARREN. All right. Good. Thank you.

I want to ask a question about risk pricing. You raised the point, Mr. Wallison, that you think the Government never gets it right. I think Senator Martinez said, "Wait a minute, I remember the

FDIC insurance model. I think they did a pretty good job." So let us call it a mixed record.

I want to ask the question in the other direction, and that is, the private market. I just went back and thought about this one. In the 1900s, we had the mortgage title insurance company, a private insurer of mortgages. In the 1920s, we had the mortgage guarantee company. I think both of those ended up collapsing in a big scandal of fraud and deception and improper pricing. And then in the 1920s—I am sorry, in the 2000s, we had the private label insurers, which I believe a significant number of those now are either already bankrupt or in the process of winding down, a lot of trouble.

So the question I want to ask, if you want us to move entirely to a private market, do we have some good examples of when the private market has done a good job of insuring mortgage pools? And I think I should start with you, Mr. Wallison.

Mr. WALLISON. Well, there are a number of things you have to look at when you consider this issue, unfortunately, because Fannie and Freddie had dominated the——

Senator WARREN. I am sorry. In the 1900s and the 1920s, I do not think we had Fannie and Freddie.

Mr. WALLISON. OK. Let me say generally, then, simply that, yes, the private market fails from time to time, but the——

Senator WARREN. Did it ever——

Mr. WALLISON. But the taxpayers, if I may continue, do not have to bail them out.

Senator WARREN. My question is: Can you give me an example of when the private market succeeded in correctly insuring mortgage pools and did not end up in collapse when the housing market reversed?

Mr. WALLISON. I cannot do that because we have always had the same system of Government involvement in the housing finance business for the last 40 or 50 years. The problem that happened recently, after the 2008 financial crisis, is that, in order to provide mortgages for the residential market, these mortgage insurance institutions, had to agree to use Fannie and Freddie's underwriting standards.

Senator WARREN. Well, Mr. Wallison, we have heard your arguments about Fannie and Freddie. That is why I started with the examples when there were no Fannie and Freddie. I will just stop at the point you are asking us to bet the entire mortgage market on a model that has absolutely no proof that it will work, that may be a problem. My time is up I see, so I will go back to the Chairman.

Chairman JOHNSON. Thank you.

Does Senator Moran have any questions?

Senator MORAN. Mr. Chairman, I have no questions. I do not want to delay the hearing, but I do appreciate the hearing being held. I think this is an important topic. The three witnesses have significant expertise and knowledge. I have read their testimony. I apologize for my presence on the Senate floor this morning instead of in this hearing room. But I am very interested in this topic, and I thank the Chair and the Ranking Member for hosting the hearing.

Chairman JOHNSON. Good. We will go to a second round, but I urge the Members to not use up the 5 minutes.

Ms. Ratcliffe, when constructing the underwriting standards for the new system, is downpayment the strongest indicator of a sustainable mortgage?

Ms. RATCLIFFE. I would say no, but I have to underscore that it is well known that downpayment does correlate with default. What our research shows—and, by the way, our program is not—the one we studied is not the only example. There is a program in Massachusetts where 15,000 mortgages were made with downpayments of 3 percent or less, and they have had default rates that have remained below prime mortgage default rates in that State.

We also have the example of the State housing finance agencies. We have recently done a survey of the majority of those agencies and collected default information on them and found that their loans, which are typically low downpayment loans to first-time home buyers, have performed quite well in the crisis as well.

So we believe that the risks associated with low downpayment lending can be mitigated. Probably the biggest mitigant for that risk is to provide a safe product, a 30-year fixed-rate mortgage, which has a predictable payment and over time builds equity in the home and also, you know, with even slight increases in income, the borrower is more and more able to—you know, their payment becomes more and more affordable over time.

So having a good product, having it be something that is transparent and well understood by the borrower, having it underwritten for ability to repay, these things all can mitigate for the risk of low downpayment lending.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman. I just have one question, and I will ask the witnesses to try to respond succinctly. This is a question that could use up my 5 minutes in your responses.

Philosophically, I am predisposed to believe that the housing market in the United States can operate without the intervention of the Federal Government. Yet I have many people who operate in the industry and many experts, like two of you on the panel today, who tell me that it cannot, that we cannot have a housing market in the United States work effectively without that Government guarantee.

And so my question to each of you is—and I will start with you last this time, Mr. Wallison, because you went first last time. You will get the last word this time. But my question is: Can you tell me succinctly why is it that a housing market in the United States cannot work or can work without a Government guarantee? Mr. Martinez?

Mr. MARTINEZ. Senator, I would say if you make the judgment that you want a 30-year mortgage, you know, I do not think you will find another example of where it can be replicated. And so the 30-year mortgage, the necessary length of time for investors and so forth to participate in a 30-year mortgage dictates that there be a Government guarantor as the ultimate backstop, which is why we put them in the last position and created some safety between the guarantor and the Government position and the credit enhancers and so forth.

So I will be, you know, as succinct as I——

Senator CRAPO. I know you can talk a long time on this.

Mr. MARTINEZ. Right, right. I will leave it alone at that point, but—and if you consider also that the to-be-announced market, and that is an arcane sort of thing, but trust me, it is incredibly important for there to be a functioning secondary market. And the TBA market will not work without a Government guarantee.

Senator CRAPO. Thank you.

Ms. Ratcliffe?

Ms. RATCLIFFE. Sure. Two points on that.

We see that there could be a private market, but we believe it was be smaller, more volatile, more expensive, and as stated, much more likely to be predominantly adjustable rate mortgages.

Another point I want to make is that a lot of times we think we are alone in having a Government support of the mortgage market, and that is because when you look at a mortgage-backed securities market, the U.S. is almost alone in having most of its mortgages funded through securitizations. But other developed countries across Europe, for example, fund their mortgages through deposits, through the banking institutions, and some to some degree through covered bonds. And those, in fact, enjoy very clear Government guarantees, both in some cases explicitly and in other cases implicitly, and we saw a lot of those guarantees acted on in 2008 in the financial crisis.

So it is not quite accurate to say that other countries do not provide a Government guarantee of their mortgage financing market.

Senator CRAPO. Thank you.

Mr. Wallison?

Mr. WALLISON. I am always amazed to hear people say that we need the Government to back a particular market. Our economy has worked for years, works today, with the private sector financing almost everything else other than housing. And what the private sector does finance turns out to be a stable market over the long term.

If we look at what the Government has financed over the last few years, since World War II, the S&Ls collapsed, the only time we have ever had an entire industry collapse; Fannie and Freddie collapsed, and we had a financial crisis, a mortgage meltdown. These were all because of the Government's involvement.

Why people believe that housing, of all the activities in the U.S. economy, has to be supported by the Government is quite beyond me, especially in terms of the record that the Government has produced.

Senator CRAPO. Thank you.

Mr. MARTINEZ. May I just make a very brief comment, which is that we do not finance cars for 30 years, and we do not finance television sets or credit cards for 30 years. I am sure he has a comeback to that.

Senator CRAPO. I will still give him the last word.

Mr. MARTINEZ. He is much smarter than I am.

Mr. WALLISON. Well, that certainly is not true, but what I would like to say is that if you go to Google and you put in "30-year fixed-rate mortgage," you will find that many mortgages are being offered without Government backing. They are jumbo mortgages, and

if they are jumbo mortgages, they are not backed in any way by the Government.

There is such a thing as a 30-year fixed-rate loan. I found one, for example, just recently. Wells Fargo is offering a 30-year fixed-rate jumbo mortgage for 12 basis points more than the Fannie Mae equivalent.

So it is not true that you cannot have a 30-year fixed-rate mortgage without the Government's backing. The 30-year loans are made all the time for business. There are hedging mechanisms that allow this to be done, and the idea that the Government has to be involved is just not accurate.

Senator CRAPO. Thank you.

Chairman JOHNSON. Senator Warner.

Senator WARNER. Although I would add that those of us who are able to qualify for jumbo mortgages is a relatively small strip of the housing marketplace. But I do appreciate, Mr. Wallison, you are absolutely consistent on all of these issues around Government backstops.

But let me just—I want to ask a question or put out again. I think there is a growing sense that we can find some commonality on this, that we can put—maybe not to the extent of all the panel will agree, but a number of backstops and a waterfall of preconditions before you would ever get to some kind of Government guarantee. I think we can even price some of that at the back end with maybe, again, this idea of this slice of a private component that would help be a market signal warning.

One of the areas that could be problematic in trying to get to yes for all of us, though, is around this issue—and I think Senator Reed raised it and Senator Menendez raised it—around affordable housing, how we think about this, where that function resides when we think affordable housing, rental housing, and other areas, how it is funded. And, again, recognizing the Chairman's request we do not want to take too long, I will maybe just ask Senator Martinez if you could talk for a moment about how you all approached this issue and where you deposited that, and how you funded it. I would appreciate it.

Mr. MARTINEZ. Well, affordable rental housing is a very big issue, and I think we dealt with that in a very forthright way, and I think there are some proposals there. I am not as prepared to talk about those as I am on the finance side. But suffice it to say that the view of the commission was that there had to be mechanisms in place to provide funding for affordable rental housing.

There was some debate on the vehicle, but, you know, the idea that the mortgage insurance deduction is a subsidy of sorts, and while it is very important, there was a lot of debate about whether that should be a function that should not only be utilized for supporting home ownership but also for rental.

Senator WARNER. And I would only ask that that is an area that the more bipartisan consensus you can find from outside expertise to see, again, how it would be funded, where it sits, how we make sure it is a clearly defined, narrow mission that does not get into mission creep in the overall housing finance market is I think something that needs some more work.

Mr. MARTINEZ. And we keep it totally separate. We did not have any function along those lines.

Senator WARNER. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman. I just have two questions, but I will be quick with them.

The first one is: I just wondered if any of you have dealt with or thought about the implications of using data tagging on mortgages so that over time we are able to create more robust information to develop a better insurance market, regardless of whether it is private or has a public backstop. Ms. Ratcliffe?

Ms. RATCLIFFE. Well, we would love that, of course, at the university. That would allow us to do more research. But I did want to draw your attention to the fact that——

Senator WARREN. That is not a bad thing.

Ms. RATCLIFFE.——the Home Mortgage Disclosure Act revisions actually are looking to have more of a mortgage identifier that could be linked so that you could find out about performance data over time. This is still being worked through, but there are some proposals on the table. It is an excellent idea.

Senator WARREN. Mr. Wallison?

Mr. WALLISON. No, that is not an issue I have looked at.

Senator WARREN. OK.

Mr. MARTINEZ. Nor us, no.

Senator WARREN. All right. Good. Thank you. And then just one other question. We have seen so much bank consolidation over the past several years, and I am particularly concerned that whatever reforms we end up doing with the GSEs that it not disadvantage the small banks and credit unions in getting access to the funds they need so that they can continue to be in the home mortgage lending business. And I know you spoke somewhat about this, Ms. Ratcliffe, but if I could just have each of you with your proposals just give us a very short summary of how you would make sure that the smaller financial institutions will still have access to the market. Ms. Ratcliffe?

Ms. RATCLIFFE. Thank you. As I mentioned specifically, we bar the large—any originator from owning, having an ownership stake of a CMI except under specialized circumstances like maybe some big cooperative type structure. And that would prevent the large originating institutions from accumulating all that risk on their balance sheets and from sort of using their market power to disadvantage and set the terms at which small institutions could access the secondary market. We think that that could actually have the effect of sort of re-creating Fannie- and Freddie-like institutions at the big banks who would also then be originators, servicers, and enjoy the backstop of the FDIC.

Senator WARREN. I do not want to put too fine a point on it, and I know I am trying to be mindful of the time. But what you are effectively saying is that the largest financial institutions should not be able to aggregate, and that is what you will count on to give adequate access to the smaller financial institutions so that they are going to have adequate funding. You are confident that is going to give them enough funding access?

Ms. RATCLIFFE. If the structure does not allow originators to operate the credit-loss-taking function, then I believe so, yes.

Senator WARREN. OK. Mr. Wallison?

Mr. WALLISON. I think, first of all, you have to start with the fact that the real danger to smaller institutions, the thing that is driving them out of the mortgage business, is the Dodd-Frank Act and the——

Senator WARREN. Mr. Wallison, we——

Mr. WALLISON.——new regulations that have been put upon them or will be——

Senator WARREN. Mr. Wallison, we can have that debate, and we are going to disagree on that.

Mr. WALLISON. All right. Of course, but——

Senator WARREN. But the question I have——

Mr. WALLISON. Those are costs that they have——

Senator WARREN.——is your proposal——

Mr. WALLISON.——to deal with.

Senator WARREN. Excuse me, Mr. Wallison. Your proposal is to let the market take care of it. Is that right? Is there anything that assures that there will be access to the credit markets for the small financial institutions that do not have the same capacity to have securitized pools?

Mr. WALLISON. There is not anything now, but as usual, if the Government removes itself from the business, people will offer the smaller institutions, which produce very good, high-quality mortgages, an opportunity to issue their mortgages through a securitization——

Senator WARREN. Do you have any evidence that that would work?

Mr. WALLISON. You know, if you look at our economy, whenever there is an opportunity, a service is provided. If the Government is providing it, the private sector can't compete.

Senator WARREN. I will take that as a no.

Mr. WALLISON. That is why you do not see much——

Senator WARREN. Senator?

Mr. MARTINEZ. Senator, our proposal follows the model of—recommends a model similar to Ginnie Mae, and Ginnie Mae has currently in the area of 350 different issuers, and that is the model we would recommend.

Senator WARREN. Good. Thank you, Senator.

Thank you very much, Mr. Chairman.

Chairman JOHNSON. I would like to thank all of the witnesses for being here with us today, and I look forward to continuing this discussion with my colleagues to build bipartisan consensus.

This hearing is adjourned.

[Whereupon, at 11:49 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF SENATOR ROBERT MENENDEZ

Introduction—Welcoming the Panel

Thank you, Chairman Johnson and Ranking Member Crapo, and thank you to our panel of distinguished witnesses who have taken the time to be here today. We look forward to hearing their expert testimony and I applaud the efforts of this Committee in examining this issue that affects Americans every day, no matter their political beliefs.

We are here today on a very serious matter that goes to the heart of our Nation's economic growth engine and that preserves the prospects of the American dream found in home ownership; and to our commitment, for all families, who were hit hard in the recession. Some of these families I would add are still struggling to balance making ends meet while continuing to dream of a better tomorrow.

Mr. Chairman, we have done best as a Nation when we make sure we are inclusive, not exclusive. As Americans, we have always believed that when our neighbor does well, we do well. With that in mind—I think we should be aware today as we hear testimony and consider how to move forward, that in our Nation's past, we have already witnessed the prospects of a well-capitalized, wholly private housing finance system.

Within this system, there was little prospect for growth and expanded prosperity, little chance for everyday people to not only live *in* America, but own a share of its bounty.

No Mr. Chairman, it was the involvement of Government in one form or another that brought about a more robust housing industry, stability and liquidity for investors, and no doubt, this will continue to be the case for some time to come. We may surely debate in earnest though, how much or how little.

Mr. Chairman, I again thank you for your leadership and for holding this hearing and I look forward to our discussion today in the hope that, in the end, we can all work to bridge differences and bring stability to our Nation's housing finance system in the 21st century, much as the National Housing Act did for millions of Americans in the last century.

Thank you, Mr. Chairman, for your concern and leadership on this issue.

PREPARED STATEMENT OF MEL MARTINEZ

Co-Chair, Bipartisan Policy Center's Housing Commission

Tuesday, March 19, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to be here today to discuss housing finance reform. It is a pleasure to return to the Committee, and to see so many good friends and colleagues.

I serve as one of the four co-chairs of the Bipartisan Policy Center's Housing Commission. Founded in 2007 by former Senate Majority Leaders Howard Baker, Tom Daschle, Bob Dole, and George Mitchell, the BPC is a Washington-based think tank that actively seeks bipartisan solutions to some of the most complex policy issues facing our country. In addition to housing, the BPC has ongoing projects on health care, homeland security, energy, political reform, immigration, and the Federal budget.

The Housing Commission was launched in October 2011 with the generous financial support of the John D. and Catherine T. MacArthur Foundation. Along with Senator Mitchell, former Senator Kit Bond and former HUD Secretary Henry Cisneros have joined me as commission co-chairs. In total, the commission has 21 members from both political parties who bring to the table a wide variety of professional experiences.

Over the past 16 months, the commission engaged in an intensive examination of a broad range of issues in housing. We held public forums in different parts of the country, convened numerous meetings with housing providers and practitioners, consulted with dozens of experts, and commissioned several informative research projects that are available online at *www.bipartisanpolicy.org/housing*.

Late last month, we issued our report, *Housing America's Future: New Directions for National Policy,* that covers topics such as home ownership, affordable rental housing, rural housing, and the housing needs of our Nation's seniors. Today, I am going to highlight the report's key recommendations on housing finance reform.

Our Nation's system of housing finance is broken. It's been more than 4 years since Fannie Mae and Freddie Mac were placed under Government conservatorship, yet there is still no clear path forward. The commission felt there was an oppor-

tunity to fill this policy void and offer a blueprint for a new system that can support both the home ownership and rental markets of the future.

1. Recommendations on the Key Objectives of the New System

The commission reached consensus on five key objectives for this new system.

Our first objective is a far greater role for the private sector in bearing credit risk. The dominant position of the Government in the market is unsustainable. Yes, private capital is now flowing through the system, but it absorbs very little of the system's credit risk. Instead, much of that risk lies with the government—nearly 90 percent of the single-family home ownership market remains Government supported. Reducing the Government footprint and encouraging more private participation will protect taxpayers while providing for a greater diversity of funding sources.

The second objective is a continued, but more limited, role for the Federal Government as the insurance backstop of last resort. The commission recommends the establishment of an explicit, but limited, Government guarantee administered by a new entity that we call the "Public Guarantor" to ensure timely payment of principal and interest on qualified mortgage-backed securities ("MBS"). There is insufficient capacity on bank-balance sheets alone to meet our Nation's mortgage finance needs. A strong, vibrant secondary market for these securities is essential to freeing up additional capital for mortgage lending and connecting our Nation's local housing markets to global investors.

Many investors in the secondary market require a Government guarantee protecting against catastrophic credit risk as a condition of their investment. These investors are willing to assume the risk of interest-rate volatility, but are unwilling to assume the credit risk associated with the mortgages that make up a security unless these mortgages are of the highest credit quality. In the absence of a Government guarantee, investor interest in the secondary market would wane, mortgage credit would become more expensive, and widespread access to long-term, affordable, fixed-rate mortgage financing would likely disappear.

In our proposal, the Government stands in the "fourth loss" position behind three layers of private capital: mortgage borrowers and their home equity; private credit enhancers, ranging from capital market products to highly capitalized mortgage insurers; and the corporate resources of the securities' issuers and mortgage servicers.[1] (See Appendix A for an illustration of how the Government would stand in the "fourth loss" position under our proposal.) These private companies would be subject to stringent capital requirements that would enable them to weather losses similar in magnitude to those experienced during the Great Recession.

The limited Government guarantee would kick in only after the private credit enhancers standing ahead of it had depleted all of their resources. Even then, these losses would be paid for through a fully funded catastrophic risk fund capitalized through the collection over time of insurance premiums, or guarantee fees, from mortgage borrowers. In many respects, this model is similar to that of Ginnie Mae.

The third objective is the ultimate elimination of Fannie Mae and Freddie Mac over a transition period—perhaps 5 to 10 years. Like other observers, the commission believes the business model of the two Government-sponsored enterprises—publicly traded companies with *implied* Government guarantees and other advantages—should not be reproduced.

The commission recognizes that a dynamic and flexible transition period will be necessary before the new, redesigned housing finance system is fully functioning. During this period of transition, it will be critical to avoid market disruption and to adjust course, when necessary, in response to shifts in the market and other critical events. The goal should be transition, not turbulence.

As first steps toward the new system, we support the continuation of current efforts to reduce the Government footprint through reduced GSE loan limits and sale of the GSE portfolios. We also believe the GSE guarantee-fee pricing structure should move closer to what one might find if private capital were at risk.

The transition to the new system could be facilitated by continued use of existing capabilities at Fannie Mae and Freddie Mac. They have skilled staff, established processes, and state-of-the-art technologies that could and should be tapped. We can also build on the good work of the Federal Housing Finance Agency ("FHFA") in

---

[1] Under the Commission's proposal, the issuer and mortgage servicer do not bear direct credit risk. That risk is borne by the private credit enhancer. However, the issuer and the servicer do bear other risks that help to shield the Government from loss. The issuer is responsible for the representations and warranties associated with the mortgage, and the servicer is responsible for the timely payment of principal and interest to investors out of corporate resources (as is currently the case with Ginnie Mae), although the servicer should eventually be reimbursed for this payment by the private credit enhancer.

laying out a plan for a single securitization platform and developing a model pooling and servicing agreement.

The fourth objective is ensuring access to safe and affordable mortgages for all borrowers. This is a core principle for the commission—the housing finance system of the future must be one from which all Americans can benefit on equal terms. The commission also believes that access to the Government-guaranteed secondary market must be open on full and equal terms to lenders of all types, including community banks and credit unions, and in all geographic areas. Again, Ginnie Mae's success in empowering smaller institutions to participate in its programs is instructive here.

And, finally, our fifth objective is for the Federal Housing Administration ("FHA") to return to its traditional mission of primarily serving first-time home buyers and borrowers with limited savings for downpayments. The recent concerns over the solvency of FHA's single-family insurance fund only underscore the urgency of what the commission has proposed—that far more risk-bearing private capital must flow into our Nation's housing finance system. A system in which private capital is plentiful will reduce the pressure that is sometimes placed on the FHA to act as the mortgage-credit provider of last resort and allow it to perform its traditional missions more effectively.

Our proposals for reforming the *rental,* or multifamily, housing finance system are rooted in the same principles as single-family reform: the gradual wind down of the GSEs; a greater role for at-risk private capital; a continued Government presence through a limited "catastrophic" guarantee; and reform of FHA to improve administrative efficiency and avoid crowd-out of the private market.

In addition, an "affordability" requirement for issuers of securities will ensure that the system primarily supports rental housing affordable to low- and moderate-income households.

2. The Actors in the New System

The commission's report goes into considerable detail about the individual components of the housing finance system we envision. It describes the structure and responsibilities of the Public Guarantor that will administer the limited catastrophic backstop. And it outlines the roles of the other actors in this new system—the originators, mortgage servicers, issuers of securities, and the private entities that will "credit enhance" these securities. Let me now take a moment to briefly describe the responsibilities of these actors in the new system we propose. More detail can be found in the commission's report.

a. Securitization-Approved Issuers

As noted above, the commission recommends a model similar to Ginnie Mae, where approved lenders are the issuers of mortgage-backed securities. The functions of an issuer of securities include:

- *Obtain certification from the Public Guarantor* that it is qualified to issue MBS based on such factors as (i) ability to meet credit and capital standards and cover all of the predominant loss risk through a separate well-capitalized credit enhancer, and (ii) capacity to effectively pool mortgages.
- *Ensure that the guarantee fee is paid for* and collected from the borrower along with all other fees and fully disclosed to the borrower as a part of originating the mortgage.
- *Issue the mortgage-backed securities* and, where appropriate, sell the MBS to investors through the To-Be-Announced ("TBA") market.[2]
- *Retain responsibility for representations and warranties* under the terms specified by the Public Guarantor.

b. Servicing

Under our proposal, servicers would need to be qualified by the Public Guarantor. Responsibilities of a servicer include:

---

[2] The TBA market was established in the 1970s with the creation of pass-through securities at Ginnie Mae. It facilitates the forward trading of MBS issued by Ginnie Mae, Fannie Mae, and Freddie Mac by creating parameters under which mortgage pools can be considered fungible. On the trade date, only six criteria are agreed upon for the security or securities that are to be delivered: issuer, maturity, coupon, face value, price, and the settlement date. Investors can commit to buy MBS in advance because they know the general parameters of the mortgage pool, allowing lenders to sell their loan production on a forward basis, hedge interest rate risk inherent in mortgage lending, and lock in rates for borrowers. The TBA market is the most liquid, and consequently the most important, secondary market for mortgage loans, enabling buyers and sellers to trade large blocks of securities in a short time period.

- *Make timely payment of principal and interest* should the borrower be unable to do so. The servicer will advance the timely payment of principal and interest out of its own corporate funds and will be reimbursed by the private credit enhancer at the time the amount of the loan loss is established.
- *Work with the borrower* on issues related to delinquency, default, and foreclosure and advance all funds required to properly service the loan.

c. Credit Enhancement

The commission's proposed single-family housing finance system depends on credible assurance that private institutions will bear the predominant loss credit risk, will be capitalized to withstand significant losses, and will provide credit that is generally unrestricted with little leverage. As such, private credit enhancers will bear the risk on the mortgages they have guaranteed until they go out of business or have met their full obligation, as defined by the Public Guarantor, to stand behind their guarantee. Private credit enhancers will generally be single-business, monoline companies and will be required to:

- *Provide regular reports to the Public Guarantor* on the nature of the credit enhancement, who holds the risk, the amount and nature of the capital they hold, and other measures of credit strength. These measures would include a quarterly stress test to determine that available capital is adequate, with a "capital call" to assure there are sufficient reserves to protect the Government guarantee from being tapped except in extreme cases.
- *Establish underwriting criteria* for the mortgages and mortgage pools they will be guaranteeing beyond the baseline underwriting criteria established by the Public Guarantor.
- *Reimburse servicers for their timely payment of principal and interest and other costs* at the time the amount of the loan loss is established. This reimbursement is paid out on a loan-by-loan basis until the private credit enhancer runs out of capital and goes out of business.
- *Establish and enforce servicing standards* (in conjunction with national servicing standards) in order to ensure that the interests of the private credit enhancer and servicer are fully aligned.
- *Provide credit enhancement with standard, transparent, and consistent pricing to issuers of all types and sizes,* including community banks, independent mortgage bankers, housing finance agencies, credit unions, and community development financial institutions.
- *Meet credit enhancement requirements* through one or a combination of the following options: (1) well-capitalized private mortgage insurance at the loan level for any portion of the loan where specific capital requirements are established and the servicer and/or Public Guarantor has the ability to demand margin calls to increase capital if there is an adverse move in house prices; (2) capital market mechanisms where the amount of capital required to withstand severe losses is reserved up front, either through a senior/subordinated debt model with the subordinated piece sized to cover the predominant risk or approved derivatives models using either margined Credit Default Swaps or fully funded Credit Linked Notes; and (3) an approved premium-funded reserve model, where a premium-funded reserve is established, either fully capitalized at the outset or where the reserve builds over time.

These approaches to meet capital requirements are designed to ensure that private capital will stand ahead of any Government guarantee for catastrophic risk. The Public Guarantor will establish the minimum capital levels required to survive a major drop in house values and will require any private credit enhancer to have sufficient capital to survive a stress test no less severe than the recent downturn (*e.g.,* a home price decline of 30 to 35 percent, which would correspond to aggregate credit losses of 4 to 5 percent on prime loans).

d. Government Guarantee for Catastrophic Risk

Under the commission's proposal, the Public Guarantor would guarantee the timely payment of principal and interest on the MBS, but this guarantee would be triggered only after all private capital in front of the guarantee has been expended. The guarantee would be explicit, fully funded, and actuarially sound, and the risk would apply only to the MBS and not to the equity and debt of the entities that issue and/or insure the MBS. Other functions of the Public Guarantor would include:

- *Establish the level of capital* necessary to ensure that private-sector participants in the housing finance system (issuers, servicers, and private credit enhancers) are all properly capitalized.
- *Establish the guarantee fees* to be collected from the borrower to cover the operating costs of the Public Guarantor and to offset catastrophic losses in the event of a failure of the private credit enhancer and/or servicer failure. For both the single-family and rental housing markets, a reserve fund would be established for catastrophic risk that will build over time.
- *Ensure the actuarial soundness of the funds* through careful analysis and the use of outside expertise, and report to Congress regularly regarding their financial condition.
- *Ensure access to the Government-guaranteed secondary market on full and equal terms* to lenders of all types, including community banks, independent mortgage bankers, housing finance agencies, credit unions, and community development financial institutions. The Public Guarantor must ensure that issuers of securities do not create barriers using differential guarantee-fee pricing or other means to unfairly restrict or disadvantage participation in the Government-guaranteed secondary market.
- *Provide one common shelf* for the sale of Government-guaranteed securities to offer greater liquidity for the market as well as establish an equal playing field for large and small lenders.
- *Establish a single platform* for the issuing, trading, and tracking of MBS. With multiple private issuers, this platform could provide greater uniformity and transparency, and therefore lead to greater liquidity.
- *Create and enforce uniform pooling and servicing standards governing the distribution of mortgage proceeds and losses to investors and ensuring compliance with relevant Federal tax laws.*
- *Encourage loan modifications when a modification is expected to result in the lowest claims payment on a net present value basis.* The Public Guarantor should require participants in the new Government-guaranteed system to structure and service securities in a way that would facilitate such loan modifications.
- *Qualify private institutions* to serve as issuers of securities, servicers, and private credit enhancers of MBS. The Public Guarantor will also have the power to disqualify an issuer, servicer, or a private credit enhancer if it determines that requirements and standards are not met.
- *Establish loan limits, under the direction of Congress,* so that the loans backing the Government-guaranteed MBS will be limited based on the size of the mortgage and any other criteria Congress may prescribe.
- *Set standards for the mortgages* that will be included in the MBS, including baseline underwriting criteria, permissible uses of risk-based pricing, and clear rules of the road related to representations and warranties.
- *Specify standards for mortgage data* and disclosures.

For a graphic illustration of how the new system proposed by the commission would work, see Appendix B.

The commission envisions the establishment of a single Public Guarantor with responsibility for both the single-family and rental housing markets. The Public Guarantor would consist of two separate divisions each with responsibility for administering its own separate catastrophic risk fund. Each division would also establish its own approval standards for lenders, issuers, servicers, and private credit enhancers as well as underwriting standards, predominant loss coverage requirements, and catastrophic guarantee fees.

In the commission's view, the Public Guarantor should be established as an independent, wholly owned Government corporation. As a Government corporation, the Public Guarantor will be a self-supporting institution that does not rely on Federal appropriations but rather finances the two catastrophic funds and its own operational expenses through the collection of guarantee fees. The Public Guarantor should operate independently of any existing Federal department and, with this greater independence, should be able to respond more quickly to contingencies in the market and operate with greater efficiency in making staffing, budgeting, procurement, policy, and other decisions related to mission performance.

The commission recommends that the Public Guarantor be led by a single individual, appointed by the President of the United States and confirmed by the U.S. Senate, who would serve a director. The commission also recommends the establishment of an Advisory Council to the Public Guarantor consisting of the chairman of

the Board of Governors of the Federal Reserve System as chairman of the Council, along with the director of the Public Guarantor, the secretary of the U.S. Department of the Treasury, and the secretary of the U.S. Department of Housing and Urban Development. The Advisory Council would meet on at least a quarterly basis to share information about the condition of the national economy, marketplace developments and innovations, and potential risk to the safety and soundness of the Nation's housing finance system.

3. Potential Impact on Mortgage Rates

While the new housing finance system proposed by the commission will minimize taxpayer risk, this protection will come at the cost of higher mortgage rates for borrowers. Three factors will contribute to the added costs:

First, our proposal calls for a far greater role for the private sector in mortgage finance, with private capital taking the predominant loss risk and standing ahead of a limited Government guarantee. Private credit enhancers will charge a fee to cover the cost of private capital to insure against the predominant loss if a mortgage default occurs.

Second, the Public Guarantor will charge an unsubsidized fee to cover catastrophic risk should a private credit enhancer be unable to fulfill its obligations to investors.

Third, the Public Guarantor will be structured as an independent, self-supporting Government corporation that finances its activities through an operating fee.

The borrower will indirectly pay for all three of these activities through a guarantee fee that is included in the mortgage rate.

Analysis by Andrew Davidson & Co., Inc., using two research methods and a pool of nearly 5,000 conforming loans originated in 2012, provides a range of estimates of the possible costs of the commission's recommendations. Utilizing this pool of loans, Davidson & Co. estimates the guarantee fees paid by a borrower with no mortgage insurance will range from 59 to 81 basis points.[3] By comparison, the guarantee fees for mortgages now supported by Fannie Mae and Freddie Mac are currently in the range of 50 basis points (including a 10 basis point charge paid to the U.S. Treasury to finance the payroll tax deduction). Some of these mortgages with higher loan-to-value ratios are also supported by private mortgage insurance.

4. A Path Forward

The commission has proposed a plan to substantially reduce Government intervention in the housing market and protect the taxpayers, while ensuring the broad availability of affordable mortgage credit. I believe it strikes the right balance among competing policy goals, and deserves your consideration.

The commission recognizes there may be sound alternative approaches to achieving the same objectives, but the key to success is first achieving bipartisan consensus on what these objectives are. It is our hope that the commission's recommendations—the product of extensive deliberations and enjoying the broad bipartisan support of its 21 members—will offer a viable way forward and serve as a catalyst for action.

As Members of the Committee know, the Federal Housing Finance Agency—under the able leadership of Acting Director Ed DeMarco—is engaged in an effort to prepare Fannie Mae and Freddie Mac for a post-conservatorship world. Without clear policy direction from Congress and the Administration, one possible and undesirable outcome of this effort is that the two institutions could become permanent wards of the State. Ironically, those who unrelentingly pursue a pre-Depression vision of a purely private mortgage market may end up hastening this outcome and strengthening the Government-dominated *status quo.* The idea of removing the Federal Government entirely from the housing market is not only bad policy; it is also unrealistic and politically unachievable. The goal should be to limit Government involvement and taxpayer exposure to the greatest extent possible, while ensuring that the system has sufficient liquidity to meet the mortgage needs of the American people.

5. Short-Term Obstacles to Market Recovery

As a final note, the commission has identified several factors that continue to stall a housing recovery in the immediate term. These factors are:

- Overly strict lending standards, which now go well beyond those in place before the housing bubble;
- Lack of access to credit for well-qualified self-employed individuals;

[3] Andrew Davidson & Co., Inc., has prepared a working paper on this topic that provides the details of their analysis. See *Modeling the Impact of Housing Finance Reform on Mortgage Rates* found on the BPC Housing Commission Web site at *www.bipartisanpolicy.org/housing.*

- Put-back risk—that is, the risk that lenders will be required to buy back a delinquent loan from Fannie Mae, Freddie Mac, or FHA;
- Ongoing issues with appraisals, including calls for multiple reappraisals sometimes just days before closing that can derail home sales;
- Application of FHA compare ratios; and
- Uncertainty related to pending regulations and implementation of new rules.

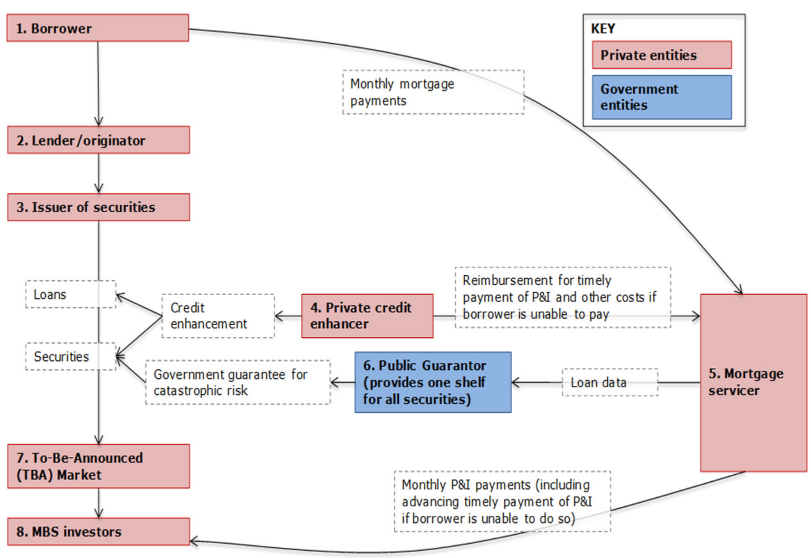
While not our primary focus, we believe these issues must be resolved before the housing market can fully recover.

Thank you for your attention. I look forward to your questions.

Appendix A. **The "capital stack" in a reformed housing finance system**

Resources	Entity	Risk/Responsibility
1. Household resources	Homeowner/ mortgage holder	Down payment and home equity
2. Corporate resources	Originator/ Issuer	Representations and warranties
	Servicer	Timely payment of principal and interest (to be reimbursed by the private credit enhancer)
3. Private credit enhancer resources	Private credit enhancer	Credit risk – with sufficient capital set aside to survive a stress test no less severe than the recent downturn (e.g., home price decline of 30 percent to 35 percent, which would correspond to aggregate credit losses of 4 percent to 5 percent of prime loans)
4. Government resources	Government guarantee for catastrophic risk/ Public Guarantor	Catastrophic credit risk (with dollars set aside in a catastrophic risk fund paid for by a portion of the g-fee)

Appendix B. Flow of mortgages



PREPARED STATEMENT OF PETER J. WALLISON

ARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES
AMERICAN ENTERPRISE INSTITUTE *

TUESDAY, MARCH 19, 2013

Thank you for the invitation to testify before the Committee today, and to discuss the future of the U.S. housing finance system.

Many have pointed out that the Dodd-Frank Act ignored the fundamental causes of the financial crisis it was supposed to address. They note that the act imposed new, costly and growth inhibiting regulations on the entire financial system, but it failed to reform the U.S. Government's housing policies. These fostered the creation of 28 million subprime and otherwise weak loans by 2008 and the development of a massive housing bubble between 1997and 2007. When the bubble began to deflate, weak and high risk loans began to default in unprecedented numbers, driving down housing values and weakening financial institutions in the U.S. and around the world.

In this testimony, I will outline the major provisions of a proposal for housing finance reform that I and two AEI colleagues, Alex Pollock and Edward Pinto, developed in response to a white paper issued by the Obama administration in February 2011. Although no specific action was ever proposed by the Administration, the Administration white paper advanced three options for housing finance reform. One of those options was what I would call a completely free market system. The proposal I will describe today was embodied in a much longer paper, entitled "Taking the Government Out of Housing Finance: Principles for Reforming the Housing Finance Market," that we issued in March 2011. That paper was intended to fill out the free market option that the Administration had proposed and respond to questions raised in its white paper. I respectfully request that the complete proposal I will summarize today be included with the records of this hearing.

Our proposal is based on four principles that we believe should be the foundation of U.S. housing policy in the future. If these principles had been in place for the last 20 years, we would not have had a financial crisis in 2008. But that is water over the dam. We must now concentrate on reforming the U.S. housing finance system so that we do not face another housing-induced crisis in the future.

The four principles are the following:

I. The housing finance market—like other U.S. industries and housing finance systems in most other developed countries—can and should function without any direct Government financial support.

Under this principle, we note that the huge losses associated with the S&Ls and Fannie and Freddie—as well as the repetitive volatility of the housing business—did not come about in spite of Government support for housing finance but *because* of Government backing. Government involvement not only creates moral hazard but sets in motion political pressures for further and more destructive actions to bring benefits such as "affordable housing" to constituent groups.

Although many new ideas for Government involvement in housing finance are being circulated in Washington, they are not fundamentally different from the policies that have caused the losses already suffered by the taxpayers, as well as the losses still to be recognized through Fannie and Freddie.

The fundamental flaw in all these ideas is that the Government can establish a risk-based price for its guarantees or other support. Many examples show that this is beyond the capacity of Government, and is in any case politically infeasible. The problem is not solved by limiting the Government's risks to mortgage-backed securities (MBS); the fact of the Government's guarantee eliminates an essential element of market discipline in this case—investors' risk-aversion—so that the outcome will be the same: underwriting standards will deteriorate, regulation of issuers will fail, and taxpayers will take losses once again.

II. To the extent that regulation is necessary, it should be focused on assuring mortgage quality.

This principle is based on the idea that high quality mortgages are good investments and have a history of minimal losses. Instead of relying on a Government guarantee to assure investors as to the quality of mortgages or MBS, we should simply make sure that the mortgages made in the U.S. are predominantly prime mortgages. We know what is necessary to produce a prime mortgage; these are outlined

* The views expressed are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

in our proposal. Before the affordable housing requirements were imposed on Fannie and Freddie in 1992, these were the standards that kept losses in the mortgage markets at minimal levels.

Experience has shown that some regulation of credit quality is necessary to prevent the deterioration in underwriting standards. The natural human tendency to believe that good times will continue—and "this time is different"—will always spawn bubbles in housing as in other assets. Bubbles in turn spawn subprime and other risky lending, as most participants in the housing market come to believe that housing prices will continue to rise, making good loans out of weak ones. Bubbles and the losses suffered when they deflate can be minimized by interrupting this process—by inhibiting through appropriate regulation the creation of weak and risky mortgages.

III. All programs for assisting low-income families to become homeowners should be on-budget and should limit risks to both homeowners and taxpayers.

Our proposal recognizes that there is an important place for social policies that assist low-income families to become homeowners. But these policies must balance the interest in low-income lending against the risks to borrowers themselves and the interests of the taxpayers. In the past, affordable housing and similar policies have sought to produce certain outcomes—for example, an increase in home ownership—without concern for how this goal would be achieved. The quality of the mortgages made under social policies can be lower than prime quality—the taxpayers may take risks for the purpose of attaining some social goods—but there must be limits placed on riskier lending in order to keep taxpayer losses within boundaries set by Congress and included in the budget.

IV. Fannie Mae and Freddie Mac should be eliminated as GSEs over time.

Finally, Fannie and Freddie should be eliminated as GSEs and privatized—but gradually, so that the private sector can take on more and more of the secondary market as the GSEs depart. The gradual withdrawal of the GSEs from the housing finance market should be accomplished by reducing the GSEs' conforming loan limits by 20 percent each year, according to a published schedule embodied in statute so that the private sector knows what to expect. These reductions would apply to the conforming loans limits for both regular and the high cost areas. Banks, S&Ls, insurance companies, pension funds and other portfolio lenders will be supplemented by private securitization, but Congress should make sure that it doesn't foreclose opportunities for other systems, such as covered bonds.

These principles are the underpinning of a plan that assumes that housing, like virtually every other sector of the U.S. economy, can and should be privately financed, and that the private market will produce a low-cost and stable system for financing homes.

In the white paper it released in February 2011, the Obama administration recognized the advantages for the economy and the taxpayers inherent in a free market housing finance system:

> The strength of this option is that it would minimize distortions in capital allocation across sectors, reduce moral hazard in mortgage lending and drastically reduce direct taxpayer exposure to private lenders' losses. With less incentive to invest in housing, more capital will flow into other areas of the economy, potentially leading to more long-run economic growth and reducing the inflationary pressure on housing assets. Risk throughout the system may also be reduced, as private actors will not be as inclined to take on excessive risk without the assurance of a Government guarantee behind them.[1]

I can't improve upon this statement, especially when we consider the consistent failure of all Government-based efforts to assist home ownership. In the post-war period, despite all the changes in the U.S. economy, there have been only two instances in which an entire industry has collapsed, with terrible consequences for the economy and the American people as homeowners and taxpayers. These disasters—the collapse of the S&Ls in the late 1980s and the insolvency of Fannie and Freddie about 20 years later—were the result of Government policies established for the purpose of helping Americans buy homes.

We could do it again. There are now many groups suggesting imaginative ways to get the Government back into the housing business while avoiding, they claim, the mistakes of the past. These are illusions; the Government's involvement in the

[1] Departments of Treasury and HUD, *Reforming America's Housing Finance Market,* 27.

housing finance business will always result in losses because it distorts incentives and creates moral hazard.

The disaster of Fannie and Freddie is a case in point. The two GSEs, for good reason, were widely believed to enjoy the backing of the Federal Government. This was denied repeatedly by the Government, but in the end—when they became insolvent—the markets were correct that the Government would rescue them. Proponents of Government involvement have now turned this into a general principle that the Government will always step in to rescue the housing market—thus creating a reason for the Government to be there from the beginning.

Because Fannie and Freddie enjoyed the implicit backing of the Government, they had access to funds at rates that were only slightly more than Treasury's. This enabled them to dominate the housing finance market and provide substantial profits to their shareholders and large compensation packages for their officials. Moreover, and most important, because of their Government backing no one cared about the risks they were taking. This was moral hazard, and it is moral hazard that is the unavoidable accompaniment to every Government program that attempts to assist the housing system.

The fact that the GSEs could use their Government support to produce slightly lower rates for middle class home buyers made them a target for the supporters of other groups, both inside and outside Congress. In 1992, under pressure from community activists, Congress passed legislation that was intended to extend the GSEs' largesse to low-income borrowers, and in the 2000s—under pressure from lawmakers who represented well-to-do districts-these benefits were also extended to high income groups. This is the way the Government works in a democracy. It cannot be otherwise. Whatever benefits the Government provides to some groups will eventually be extended to others. This is one of the reasons that the Government should be kept out of the housing finance business. Even if a program is started on a reasonable basis, it is inevitably expanded and its costs and subsidies increased until it causes huge losses for the taxpayers and sometimes outcomes that are even worse.

The affordable housing goals are a particularly good example. Enacted in 1992, they originally required that at least 30 percent of the mortgages Fannie and Freddie bought had to be made to borrowers at or below the median income where they lived. But this modest requirement, that was probably easy to meet, was extended and tightened by HUD over succeeding years, so that by 2000 the Clinton administration adopted a 50 percent goal and the Bush administration pushed this requirement to 55 percent.

In order to meet these quotas, the GSEs had to abandon their traditional focus on prime mortgages and substantially loosen their underwriting standards. The rest is history, as they say. By 1995 they were buying mortgages with 3 percent downpayments, and by 2000 they were accepting mortgages with no downpayment at all. So by 2008, these two firms, with gold-plated franchises and the ability to dominate the largest market in the United States, became insolvent, requiring the taxpayers, thus far, to keep them operating with more than $180 billion in financial support.

This or something like it will happen every time we put the Government into the housing finance business. As too many people have already said, too many times, it is a sign of insanity to do the same thing over and over while expecting a different result.

How a private housing finance system would work

How, then, would a private system work? Our proposal is based on the simple idea that the housing finance market will operate steadily and stably if a high preponderance of the mortgages it processes through securitization are prime loans.

To achieve this will require a degree of regulation. That may come as a surprise to some who regard me and my AEI colleagues as "free market ideologues," but in fact all believers in the superiority of free markets realize that regulation is necessary and appropriate in cases of market failure.

We believe that the growth of housing bubbles, a natural phenomenon in free markets, is an example of market failure. Human beings simply cannot avoid the idea that this time it's different—that the unprecedented growth they see around them is not a bubble but the reflection of a real change in how the world works. So they continue to buy until the bubble collapses.

That is not terribly harmful in commodity markets; the players there can generally take their losses. But in the housing market, as we have seen since the collapse of the giant bubble that developed between 1997 and 2007, the development and ultimate collapse of a bubble can be very destructive.

The reason such a large bubble developed is that housing bubbles tend to suppress delinquencies and defaults. As long as housing prices are rising, people who are in danger of default can refinance or sell the home for more than the amount of the mortgage. As weaker and weaker mortgages do not seem to be producing more delinquencies and defaults, lenders go further and further out on the risk curve and investors in MBS do not get the signals that should tell them their risks are increasing. The way to stop this from happening is to assure to the extent possible that only prime loans are securitized.

Our proposal, accordingly, would require that only prime mortgages be permitted into the securitization system. Subprime mortgages could be made, of course, but these would have to be held on private balance sheets and not securitized. Subprime lending can be a good business for people who understand the risks.

This is the only regulation we propose, but we believe it will be the foundation of a stable mortgage system if Congress can restrain itself from loosening underwriting standards again. Before the advent of the affordable housing goals, when Fannie and Freddie would only buy prime mortgages, the housing finance system was stable over all. Local bubbles developed, but could not grow to national proportions because the market for subprime loans was small without the GSEs' support. We believe a market like that can be recreated through regulation that assures only prime mortgages are securitized.

Let's be clear where the problem lies. Community activists, realtors and homebuilders want loose underwriting standards. Loose standards mean more people can buy homes, but none of these groups suffer the losses when the market collapses as it did in 2008. Who is visiting congressional offices asking for tighter mortgage underwriting standards? The answer is no one. Those who suffer are the taxpayers and the families that bought homes they couldn't afford.

The recent announcement of the Qualified Mortgage rule reflects an acceptance of the idea that the Government—which will accede to the wishes of the Housing Industrial Complex—will loosen underwriting standards. Under the rule, once a lender determines that a borrower can afford the mortgage, there is no need to impose any requirement for a downpayment or a good credit history. All that is required is to obtain the approval of the GSEs or FHA and the mortgage can be considered a prime loan. That puts the whole question of mortgage quality back in the hands of the Government, which has shown that it will worry more about increasing the availability of mortgage credit than creating a stable housing finance market.

Reasonable underwriting standards will not limit the availability of mortgage credit for those who can afford to carry the cost of a home. When Fannie and Freddie were establishing the standards for prime loans, and accepting only prime loans, the homeownership rate in the United States was 64 percent. In 1991, the great majority of conventional loans (defined as being Fannie eligible, other than by loan size) had the following characteristics:[2]

- 98 percent were loans on properties occupied as a primary or secondary residence.
- 94 percent were loans with a loan-to-value ratio (LTV) of 90 percent or less.
- 98 percent were to borrowers with one or no mortgage late payments at origination and 85 percent had two or fewer nonmortgage late payments at origination.
- 90 percent were loans with housing and total debt-to-income ratios of less than 33 percent and 38 percent, respectively.
- All loans had to be underwritten based upon verified income, assets, and credit.[3]

This was not, however, what the mortgage market looked like in 2008 after the effect of the affordable housing goals. Then, half of all mortgages—28 million loans—were subprime or otherwise weak because of low downpayments or other deficiencies. By 2008, the homeownership rate was almost 70 percent, but we paid a terrible price—a financial crisis—for adding that additional 5 percent to the home ownership totals.

Where would financing come from?

The next issue is who will buy mortgages and MBS that are not Government guaranteed. One of the most common objections to a fully private housing finance

[2] Data from Fannie Mae's random—sample review covering single-family acquisitions for the period October 1988–January 1992, dated March 10, 1992.

[3] Fannie stopped acquiring low-doc or no-doc loans in 1990. Freddie followed suit in 1991. See "Haste Makes . . . Quick Home Loans Have Quickly Become Another Banking Mess," *Wall Street Journal,* July 5, 1991.

system is that the customary buyers of GSE MBS will not accept the risk of MBS that are not Government-backed. That may be true, but the customary buyers of Government-backed MBS are not the only possible buyers. As discussed more fully at the end of this testimony, where I deal with all the traditional objections to a private financing system, the natural buyers of private MBS will be insurance companies, private pension funds and mutual funds, all of which are looking for long-term investments to match their long-term liabilities.

According to the Fed's Flow of Funds data, these investors—which collectively have about $21.5 trillion to invest—do not buy any significant amount of GSE or Ginnie MBS today. The reason is that these investors get paid for taking credit risk, and in the case of Ginnie and GSE MBS the risks have already been taken—by the taxpayers. As a result, the yields on these securities are simply not large enough to pay for their long-term liabilities. Instead, today, they are buying low quality corporate debt, which is risky but pays well.

If there were a steady flow of MBS based on prime mortgages, these financial institutions would be avid buyers as long as they can be assured of the quality of the underlying loans.

That assurance, under our proposal, would be provided by mortgage insurance (MI), which places the insurer's capital ahead of the investor's. We believe that the MI industry can be resuscitated into a viable system for providing assurance to institutional and other buyers of MBS. Recently, several new MI companies have been formed and capitalized, and legacy carriers have raised substantial additional capital, showing that investors believe that mortgage insurance has a future in the housing finance business once the GSEs are wound down and FHA limited to low-income first-time home buyers.

Mortgage insurers do credit underwriting and place their capital at risk when they write their policies. This will provide assurance to institutional investors and others that the risks of buying private MBS have been assessed and covered by independent capital. We suggest that mortgage insurance provide coverage of mortgage defaults down to 60 LTV. Below that level, experience suggests that the losses are so few that credit enhancement is not necessary.

In discussions with mortgage insurers, we were advised that the combined cost of MI for the coverage of prime mortgages included in any privately securitized pool would permit private MBS to fund a freely prepayable 30-year fixed-rate prime loan with an all-in annual cost about 20 basis points higher than Fannie's cost for the same loan. This of course assumes a normal market, not one in which the Fed is buying GSE MBS. If the Administration continues to increase the GSEs' guarantee fees in order to provide more protection for the taxpayers, and a normal market returns, that difference could narrow significantly.

Accordingly, a private system of housing finance would operate at close to the cost of the current Government-dominated system, without involving the risk that the taxpayers will eventually have to come to the rescue.

Small lenders and community banks.

The Government's involvement in the housing finance market through Fannie and Freddie distorted the market's structure. Because the GSEs were able to bid more for mortgages than any competitors, they drove competitors from the secondary mortgage market and created a duopsony (a market with only two buyers). They were then able to discriminate among their suppliers, providing better returns to those, such as Countrywide,[4] who provided the mortgages that they wanted, and penalizing those—primarily the small banks and S&Ls—that were unable to compete in the volume they could supply. Congress has now banned this behavior, but through the Dodd-Frank Act and the Consumer Financial Protection Bureau has now created more obstacles for community banks to overcome.

The private market that will develop if our proposal is enacted will be entirely different from what existed before. Most mortgages will be prime loans—the kinds of loans that the small and community banks usually originate. These loans will be highly sought after because they will not only be good investments, but also the only kind of mortgage that could be securitized. Since most mortgages will have the same prime characteristics, the key function in this new market will be aggregating the mortgages into pools for securitization.

[4] "Mortgage Bankers Association chief economist Jay Brinkmann said the pricing strategies that Fannie and Freddie pursued contributed to the concentration of mortgage lending within the largest banks. The GSEs offered reduced 'guarantee fees' for their largest customers, which placed smaller lenders at a competitive 'disadvantage,' he told the NABE annual conference." See "NY Fed Thinks Megabanks May Be the New GSEs," *National Mortgage News,* March 16, 2011.

This is a role that can be performed by the small and community banks, perhaps through the creation of a jointly owned and operated securitization facility, enabling the members to capture the profits that they previously had to give up to Fannie and Freddie or to their larger competitors. All that is necessary is regulatory approval to set up one or more joint ventures that will aggregate the mortgages produced by the members and prepare them for sale through securitization, or to institutional buyers who want to hold whole mortgages.

The more competitors in this field, the more innovation there will be and the lower they will push mortgage rates. This will be possible because the approach we have described relies on prime loans, a core competency of community banks and risk-based pricing.

FHA and low-income borrowers.

There are good policy reasons for Government to assist low-income families to become homeowners, but the value of this policy has to be weighed against the failure rate imposed on those ostensibly being helped as well as the cost to the taxpayers. Referring to the affordable-housing requirements imposed on Fannie and Freddie, even former House Financial Services Committee chair Barney Frank (D–MA) has noted that "it was a great mistake to push lower-income people into housing they couldn't afford and couldn't really handle once they had it."[5] Moreover, any program of this kind must be on budget and contain mortgage quality standards that do not create market conditions similar to those that brought on the financial crisis.

One of the ways to do this is to rein in FHA by limiting the scope of its lending, making sure its losses are sustainable over the long term, and putting it on budget through a mechanism more effective in identifying risks and losses than the Federal Credit Reform Act.

Government assistance to low-income families must not be undertaken without quality standards that limit the risks to homeowners, the Government, and taxpayers. By prescribing an outcome it wanted through the affordable housing goals, without controlling the means, the Government encouraged deteriorating underwriting standards. This inevitably led to greater lending with minimal downpayments along with lending to borrowers with impaired credit and higher debt ratios.

Thus, if Congress wants to encourage home ownership for low-income families, then the mortgages intended to implement this social policy must be subject to a defined set of quality standards—not standards as high as those for prime mortgages, but standards that will ensure that working class families and neighborhoods are not subjected to excessive failure rates, as they did with Fannie and Freddie and the FHA, causing substantial burdens for taxpayers. The Nation's experience with the FHA demonstrates not only that standards are essential, but also that Congress has to avoid the political and other pressures that tend to erode the standards over time.

Elimination of Fannie and Freddie over time.

A private housing finance market will never fully develop as long as Fannie and Freddie remain in existence, and yet it is obvious that they are essential to the current housing finance system. What is necessary, then, is a workable transition plan—one that allows the GSEs to continue to function but opens the housing finance system to private securitizers.

A key transition feature that now appears to be generally accepted calls for a gradual reduction in the conforming loan limit that sets the maximum size of the mortgages that Fannie and Freddie can purchase. This idea is also in the BPC proposal. As this limit is reduced, Fannie and Freddie will be taken out of the market for loans above the limit, enabling private securitizers gradually to expand their activity.

The elements of the transition away from GSE status should include:

Reducing conforming loan limits. We recommend lowering the conforming loan limit by 20 percent of the previous year's cap each year, starting with the current general limit for one-unit properties of $417,000 and the high-cost area limit of $625,500. These limits, for loans, mean house prices of over $500,000 and over $800,000, respectively, are financed by the Government. In contrast, according to the National Association of Realtors, the median U.S. house price is $178,900. The general limit for a one-unit property would decrease to $334,000 in year one, $267,000 in year two, $214,000 in year three, $171,000 in year four, and $137,000

[5] Larry Kudlow, "Barney Frank Comes Home to the Facts," GOPUSA, August 23, 2010, *www.gopusa.com/commentary/2010/08/kudlow-barney-frank-comes-home-to-the-facts.php#ixzz0zdCrWpCY* (accessed September 20, 2010).

in year five. The high-cost area limit for a one-unit property would decrease to $500,000 in year one, $400,000 in year two, $320,000 in year three, $256,000 in year four, and $205,000 in year five. Final termination or "sunset" of GSE status would take place at the end of year five.

Winding down investment portfolios. A useful approach to winding down the GSEs portfolios, without disrupting the market, would prohibit Fannie and Freddie from adding existing or newly acquired single-family or multifamily loans or MBS to their portfolios, with exceptions only for newly acquired loans held for a short period before securitization and the purchase of delinquent or modified loans out of an existing MBS. With no additions allowed, natural runoff should substantially reduce their portfolios over time. Under the current trajectory the portfolios will be down to about $500 billion by the end of 2018. To the extent a GSE has portfolio assets remaining at the fifth-year sunset, these should be put in a liquidating trust and defeased or sold to other investors. During the wind-down period, Fannie and Freddie should be allowed to buy only prime loans.

Repeal affordable-housing goals and taxes. Consistent with Principles I and III above, repeal the GSE (including the FHLB) affordable-housing goals and affordable-housing support fees.[6]

Privatization. At the sunset date, the conservatorship will be converted to a receivership, the equity below the Treasury's holdings will be wiped out, and the GSEs will be divided into good bank/bad bank structures. If there are buyers for the GSEs as going concerns (no longer in GSE form), or capital is available for their restructuring as fully private nongovernment entities, the good banks will be sold and the bad banks will be liquidated by creating a liquidating trust that contains all remaining mortgage assets, guaranty liabilities, and debt. The obligations of the trust will be defeased with the deposit of Treasury securities.

Objections to a private housing financing system.

Proposals for largely eliminating Government support for the housing market are usually met with a number of objections. None of them, in my view, should carry any weight when this Committee considers housing finance reform.

1. The Government will step in anyway, so it should charge in advance to protect the taxpayers. Most recently, the Bipartisan Policy Center joined many others in arguing, in support of its housing finance proposal, that if there is ever a future disruption in the housing market the Government is going to step in at some cost to the taxpayers. In that case, BPC and others have argued, this "reality" should be recognized; the Government should create some kind of insurance system to cover the costs of its future actions and thus protect the taxpayers against loss.

But the history of housing finance makes clear that the Government's role in the housing market—even if only as a brooding presence ready to act if the market collapses—will so distort the market that the Government is eventually *required* to step in. This is a repeating pattern. For one example, the Government had to rescue the S&Ls in the late 1980s and early 1990s because the Government's own support for and regulation of the S&L industry had made it impossible for the industry to survive the changes in market structure that are inevitable in an evolving financial system. Similarly, the reason we are here today, and considering what to do about the GSEs, is the result of Government housing policies that forced Fannie Mae and Freddie Mac to degrade their underwriting standards in order to comply Government housing policies.

It does not matter how light the Government's touch. In the proposal of the Bipartisan Policy Center that you will hear today, the Government will have only a standby role in the housing market, stepping in only when the market is in trouble. Otherwise, the market will consist of private companies that will securitize mortgages and mortgage insurers that will insure them.

But it's easy to see that even the limited Government role suggested by the BPC will have effects that will make a taxpayer rescue more likely. If the Government is ultimately insuring the mortgage-backed securities (MBS) issued by private companies, the buyers of those MBS will not care about the quality of the underlying mortgages or the health of either the issuers or the mortgage insurers. That will remove from the market one major incentive for market discipline, and is one of the reasons the buyers of the GSEs' debt securities didn't care about either the quality of the mortgages they were securitizing or the GSEs' financial condition.

Then there are the firms that will be issuing the MBS in the BPC plan. These firms will have shareholders and creditors. Will the creditors believe that the firms will be allowed to fail? That's doubtful. The whole premise of the BPC system is

[6] Supra. Housing and Economic Recovery Act of 2008 (HERA). HERA imposed a 4.2-basis-point fee on Fannie and Freddie's mortgage purchases (currently suspended by FHFA).

that the Government will step in if the market falters. It proposes a fund that will be available to back up the Government's obligations. This sounds like a kind of FDIC, and we know how successful that's been. Like the FDIC, these elements will diminish, if not eliminate, the market discipline that might be exercised by the creditors of the MBS issuers in the BPC plan.

In addition, because the Government is taking a risk in backing the issuers of the MBS, it will be regulating them. In the BPC plan, this will be done by something called the Public Guarantor. Prudential regulation by this Government agency will be another reason that investors in those firms or in the MBS they issue will not exercise market discipline—the Government, they will believe, is doing that job. However, the collapse of the S&Ls, the failure of thousands of banks in the late 1980s and early 1990s, and the most recent financial crisis, not to speak of the collapse of the GSEs themselves, should be ample evidence that Government prudential regulation provides no assurance whatever that the regulated entities will not fail. It is important to keep in mind that only 2 months before the GSEs were taken over their regulator reported that they were adequately capitalized.

The mortgage insurers will also have both equity investors and creditors. Again, the interest these groups may have in the health of the MIs will be tempered by the Government's presence. If the mortgage insurers should fail, the insurers' investors will believe, the Government will rescue them. Again, that is the very premise on which the BPC's proposal is based. So if the BPC and others who make this argument are correct that the Government will step in to protect the market, it is unlikely that investors in the MIs will pay much attention to their health, believing that the Government will bail them out if they should get into trouble. That, in turn, will mean that the MIs will be likely to fail because they have insured the low quality mortgages that the issuers were able to sell to investors because of the Government back-up.

The idea that the Government can protect the taxpayers by charging a premium for its guarantees also does not stand up to analysis. The Government doesn't have the incentives to charge a premium that fully compensates it for the risks it is taking, and Congress is often willing to respond to complaints from the industry that the premiums are too high and are operating as a tax on consumers. Thus, Congress just had to bail out the National Flood Insurance Program to the tune of $9.7 billion. The NFIP had been charging premiums for flood insurance for many years, but when the fund was really needed it wasn't large enough. If the Government wants to do it as a matter of policy, OK, but Congress should realize that it will always end up as a cost to the taxpayers.

The history of Government insurance programs is consistently dismal. The FDIC became temporarily insolvent in the 2008 financial crisis because Congress limited the amount it could charge for deposit insurance; the FHA is already insolvent and will have to be bailed out, the Pension Benefit Guarantee Corporation is also on its way to insolvency if not already insolvent. The pathology is always the same. The Government accumulates a fund, but the fund was too small for the occasional catastrophic event. The reason the fund is too small is that the private sector interests that are supposed to be protected want to lower their costs, and persuade Congress that the fund is large enough. So premiums are lowered, or not increased as costs rise, or stopped altogether as occurred at the FDIC. When the catastrophe occurs, as it always does when the Government is involved, the taxpayers have to pick up the tab.

And then there is moral hazard. The fact that the Government would insure building in flood zones made it possible for people to do so. In the case of housing finance programs like that proposed by the BPC, the fact that the Government—*i.e.,* the taxpayers—is there as final guarantor will mean that the whole system will operate without taking full account of, and paying for, the risks it is creating. As a result, there will be greater demand for the product—more and more and bigger and bigger homes—and the financing will get riskier and riskier. In these cases, in theory, the Government should add to the price of the insurance but is reluctant to do so. When the catastrophe comes, there will not be enough money in the fund to solve the problem and the weary taxpayers will have to pay up.

Finally, the idea that the Government will step in to protect the housing market is a self-fulfilling prophesy. As noted above, the existence of the Government backing—because of moral hazard—makes default more likely. Once a fund of some kind is established, any restrictions on its use will fade away. A wholesale collapse of the industry will not be necessary; the failure of a single insurer or issuer will be enough to bring on a rescue. After all, what is the fund for but to protect the investors in the MBS? This in itself will prove to the market that the whole system is guaranteed by the Government, removing any vestige of market discipline that might have previously existed.

2. Only the Government can assure the existence of a 30-year fixed-rate mortgage. The first thing to say about this is that the Government should not be encouraging 30-year fixed-rate mortgages. They are harmful to most families that accept them. The second thing is that, if home buyers actually want 30-year fixed-rate mortgages, the private sector already makes them available without any Government support.

There are several commonly cited advantages of a 30-year fixed-rate mortgage. It protects the borrower against rate hikes for 30 years, reduces the monthly payment, and increases the tax-deductibility of the monthly payment in the early years when most of the monthly payment consists of interest. Finally, in almost all cases the mortgage can be refinanced without penalty into another 30-years fixed mortgage at a lower interest rate if market conditions permit.

These sound like significant advantages, but that is illusory. First, most families do not stay in a home for 30 years; the average is about seven, so when families take out 30-year fixed-rate mortgages they are paying for the lender's 30-year risk when they will not ever need it. A shorter maturity mortgage is less expensive and better meets the needs of most families, which would be well served by a 5-, 10-, or 15-year fixed period, with a 20-, 25-, or 30-year amortization. Last week, Wells Fargo was offering a 30-year fixed-rate conforming (*i.e.,* nonjumbo) mortgage at a rate of 3.75 percent, and a 15-year conforming mortgage at almost a full point less, at 2.875 percent. The point is that a private market would mix and match the elements of a mortgage to better meet the needs of particular families for the lowest possible cost.

In addition, when a family that has taken out a 30-year fixed-rate mortgage finally sells its home to buy another they will not have accumulated very much equity. Most of their payment has been interest, and this interest rate has been higher than if they had chosen a 15-year loan. It is true that they have received a tax deduction for this interest payment, but that is only if they itemize their deductions, and only 33 percent of families itemize.

The idea that Government backing is required for a 30-year, fixed-rate loan has some surface plausibility. Many people who don't follow the financial markets might assume that lending money for that long a period at a fixed-rate would be too risky for the private sector. Just about everyone in Congress seems to have been visited by a representative of the Housing Industrial Complex claiming that the 30-year mortgage would not exist without Government backing.

However, anyone can prove this assumption is wrong, simply by going to Google and typing in "30-year jumbo fixed-rate mortgage." The word "jumbo" is mortgage market jargon for loans that are too large to be bought by Fannie or Freddie, or insured by the Federal Housing Administration. That means a jumbo mortgage is not backed in any way by the Government. Still, a Google search will return many offers of jumbo fixed-rate loans. I found one offered by Wells Fargo last week at 3.875 percent, about 12.5 basis points higher than the 30-year fixed-rate conforming (*i.e.,* nonjumbo) loan that Wells was offering at the same time.

In other words, Government backing is not necessary to make this loan available to homeowners, although the Government subsidy that comes with the conforming loan—where the taxpayers are taking the risk-could well be responsible for the 12.5 basis point difference in rate.

We should have no objection, of course, if homeowners want this type of loan. The question is whether the taxpayers should take on the risk of backing the entire housing finance structure in order to provide a 12.5 basis point subsidy to home buyers, most of who don't need the 30-year fixed-rate mortgage they are assuming.

Finally, we have just come through a period where everyone has seemed to recognize the dangers of leverage. Many in Congress preach fervently against excessive leverage. Perhaps they don't realize that a 30-year fixed-rate mortgage is one of the principal ways that leverage is built into the housing system. As noted above, it takes many years before a homeowner builds up equity in the home through a 30-year fixed-rate mortgage. This means that for all this time the homeowner is using credit—leverage—to carry the home. If there is a market downturn during this period, the homeowner is likely to be underwater and unable to sell the home, a victim of leverage encouraged by the Government's promotion of the 30-year fixed-rate mortgage.

3. The investors in MBS are rate buyers. They do not want to take credit risk. Without Government backing, and the assurance of a risk-free investment, it is argued, we would not be able to find investors for MBS in the U.S. and around the world.

This argument confuses cause and effect. It is true that most of the buyers of GSE and Ginnie MBS do not want to take credit risk. According to the Fed's Flow of Funds data, the principal buyers of Ginnie Mae and GSE MBS are U.S. banks, for-

eign central banks, and Federal, State and local pension funds. These entities are buyers *because* they are looking for returns without risk. If there were no Ginnie or GSE MBS, they would be buyers of Treasuries. This means that Treasury is paying more for its outstanding debt because it competes with GSE securities. In a recent memorandum, Steve Oliner, an AEI economist, and I estimated this cost to the Treasury at about $22 to $28 billion per annum, more than what the Government is now receiving in GSE dividends.

In the private sector, however, investors are compensated for taking risks. They are not generally buyers of Ginnies and GSE MBS because the taxpayers are taking the risks associated with those securities and the yields are too low to meet their long-term obligations.

Insurance companies, private pension funds and mutual funds should be the natural buyers of mortgages and MBS. These are long-term assets that would match their long-term liabilities. But as shown again by the Fed's Flow of Funds data, they are not buyers of Government-backed MBS, probably because the yields are too low when the taxpayers are assuming the risks (and not being compensated for it). In the absence of private MBS, these investors are generally buying low quality corporate securities.

If there were a steady flow of private mortgage credit in the form of whole mortgages and MBS, insurance companies, private pension funds and mutual funds—which together have about $21.5 trillion to invest—would be steady buyers. This would set up a financial win-win, in which there would be adequate credit for mortgages and a sound investment for long-term investors.

4. Without Government backing there would be no TBA market and interest rates for all mortgages would rise. This is also incorrect. The TBA (To Be Announced) market is a hedging mechanism, which allows lenders to hedge the possibility of interest rate changes between the time they lock in a rate for a borrower and the time the loan actually closes. This is done by selling the pool of mortgages forward, just as a farmer might sell his wheat or corn crop forward. Then, if the price changes, he is protected. The buyer is speculating that wheat will be worth more when delivered than it is on the date of the forward sale. So in the same way, the mortgage lender sells its pool of mortgages forward to a buyer who is speculating that the mortgages will be worth more in the future when they are ultimately delivered. There are two keys to the effective operation of a TBA market—market liquidity and a general agreement on the principal terms of the mortgages in a MBS pool.

In the current TBA market, in which the GSEs are the principal players, the liquidity is created by a convention among market participants about what they will accept as sufficient information about a particular mortgage pool. The agreement covers six factors—issuer, maturity, coupon, price, par amount and settlement date. Participants in the market agree to buy a pool of mortgages that all fall within certain previously agreed parameters. It's the agreement on these parameters not creates the liquidity, not the Government guarantee of the credit risk. The credit risk is occasionally a factor, but the purpose of the TBA market is to hedge interest rate risk, not credit risk.

Once the private market become active enough so that there is a liquid market for the purchase and sale of mortgage pools the TBA market will function.

5. Without Government involvement, a steady flow of credit to housing cannot be guaranteed. Why should housing, as opposed to all other industries, be guaranteed a steady flow of credit? Every other industry has to live with the prospect that interest rates will rise and credit will be tight. This encourages prudence and care in making commitments, reduces overbuilding and the use of leverage that has contributed to housing bubbles in the past. A steady flow of credit to housing has, ironically, been the cause of much of the volatility in the housing market in the past.

That concludes my prepared testimony.

Taking the Government Out of Housing Finance: *Principles for Reforming the Housing Finance Market*

An American Enterprise Institute
Policy White Paper

Peter J. Wallison Alex J. Pollock Edward J. Pinto

March 24, 2011

American Enterprise Institute for Public Policy Research

5/26/11 corrections

Taking the Government Out of Housing Finance: Principles for Reforming the Housing Finance Market

Peter J. Wallison Alex J. Pollock Edward J. Pinto

March 24, 2011

An American Enterprise Institute Policy White Paper

Executive Summary

We recommend that the US housing finance market of the future should be governed by four basic principles:

> Principle I: The housing finance market can and should principally function without any direct government financial support.
>
> Principle II: Ensuring mortgage quality and fostering the accumulation of adequate capital behind housing risk can create a robust housing investment market without a government guarantee.
>
> Principle III: All programs for assisting low-income families to become homeowners should be on-budget and should limit risks to both homeowners and taxpayers.
>
> Principle IV: Fannie Mae and Freddie Mac should be eliminated as government-sponsored enterprises (GSEs) over time.

With the release of the Obama administration's thoughtful report[1] on housing finance reform (February 2011), which was broadly consistent with these ideas, a bipartisan agreement on the future of housing finance has become possible.

The administration's paper outlines three options, the first of which is a largely private market. By including this idea as a key option for a Democratic administration, the report was a game changer: whether most housing in the United States should be financed in a private market is now open for consideration. In its paper, the administration raised some reasonable concerns about this option and suggested two alternatives. We address these concerns and show how to produce a robust, stable private system for originating and financing mortgages, while protecting the taxpayers.

There are two theories about the financial crisis of 2007–2008. One holds that it was caused largely by a lack of effective government regulation;[2] the other that government housing policy was primarily at fault.[3] Whether one looks at this debacle as a failure of regulation or a failure of housing policy, it is undeniable that large parts of the previous US housing finance system were guided and guaranteed by the government and that once again the taxpayers will bear the immense costs of government failure.

Many of the proposals for reforming the US housing finance market reflect the belief that institutional investors will buy securities backed by US mortgages (MBS) only if they are somehow guaranteed by the US government. To the contrary, we propose a superior alternative

---

[1] Department of the Treasury and Department of Housing and Urban Development (HUD), *Reforming America's Housing Finance Market: A Report to Congress* (Washington, DC, February 11, 2011).
[2] Financial Crisis Inquiry Commission, *Financial Crisis Report* (Washington, DC, January 2011).
[3] Peter J. Wallison, *Dissent from the Report of the Financial Crisis Inquiry Commission*, (Washington, DC: American Enterprise Institute, January 2011), www.aei.org/paper/100190.

to government guarantees—remembering that such government market interventions have led to large-scale taxpayer bailouts twice in the last generation.

Our alternative is to ensure that only prime-quality mortgages, which comprise the vast majority of US mortgages, are allowed into the securitization system. The very low delinquency and default rates on prime mortgages will be attractive investments for institutional investors and will enable the housing finance secondary market to function effectively with no government support. This will eliminate the potential for additional taxpayer losses in the future; reduce the likelihood and severity of housing price booms, busts, and attendant bubbles; and allow the eventual elimination of the GSE charters of Fannie Mae and Freddie Mac.

The four basic principles we recommend (initially outlined in an earlier draft of this paper issued in January 2011) line up remarkably well with Option 1 in the report issued by the administration. This provides an opportunity to replace Fannie Mae and Freddie Mac and adopt other housing finance reforms that will protect the taxpayers against further losses and significantly reduce the chances of another financial crisis.

The following explanations summarize our four central principles:

I. The housing finance market—like other US industries and housing finance systems in most other developed countries—can and should principally function without any direct government financial support.

Under this principle, we note that the huge losses associated with the savings and loan (S&L) debacle of the 1980s and Fannie and Freddie today did not come about *in spite of* government support for housing finance but *because of* that government backing. Government involvement not only creates moral hazard but also sets in motion political pressures for increasingly risky lending such as "affordable loans" to constituent groups.

Although many schemes for government guarantees of housing finance in various forms have been circulating in Washington since last year, they are not fundamentally different from the policies that caused the failures of the past. The fundamental flaw in all these ideas is the notion that the government can successfully establish an accurate risk-based price or other compensatory fee for its guarantees. Many examples show that this is beyond the capacity of government and is in any case politically infeasible. The problem is not solved by limiting the government's risks to MBS, as in some proposals. The government's guarantee eliminates an essential element of market discipline—the risk aversion of investors—so the outcome will be the same: underwriting standards will deteriorate, regulation of issuers will fail, and taxpayers will take losses once again.

II. Ensuring mortgage quality, and fostering the accumulation of adequate capital behind housing risk, can create a robust housing investment market without a government guarantee.

This principle is based on the fact that high-quality mortgages are good investments and have a long history of minimal losses. Instead of relying on a government guarantee to reassure investors in MBS, we should simply ensure that the mortgages originated and distributed are predominantly of prime quality. We know the characteristics of a prime mortgage, which are

defined later in this white paper. They do not have to be invented; they are well known from many decades of experience.

Experience has also shown that some regulation of credit quality can prevent the deterioration in underwriting standards, although in the last cycle regulation promoted lower credit standards. The natural human tendency to believe that good times will continue—and that "this time is different"—will continue to create price booms in housing, as in other assets. Housing bubbles in turn—by suppressing delinquencies and defaults—spawn subprime and other risky lending; investors see high yields and few defaults, while other market participants come to believe that housing prices will continue to rise, making good loans out of weak ones. Future bubbles and the losses suffered when they deflate can be minimized by interrupting this process—by focusing regulation on the maintenance of high credit quality.

III. All programs for assisting low-income families to become homeowners should be on-budget and should limit risks to both homeowners and taxpayers.

The third principle recognizes that there is an important place for social policies that assist low-income families to become homeowners, but these policies must balance the interest in low-income lending against the risks to the borrowers and the interests of the taxpayers. In the past, "affordable housing" and similar policies have sought to produce certain outcomes—such as an increase in homeownership—which turned out to escalate the risks for both borrowers and taxpayers. The quality of the mortgages made in pursuance of social policies can be lower than prime quality—taxpayers may be willing to take risks to attain some social goods—but there must be quality and budgetary limits placed on riskier lending to keep taxpayer losses within known and reasonable bounds.

IV. Fannie Mae and Freddie Mac should be eliminated as government-sponsored enterprises (GSEs) over time.

Finally, Fannie and Freddie should be eliminated as GSEs and privatized—but gradually, so the private sector can take on more of the secondary market as the GSEs withdraw. The progressive withdrawal of the GSEs from the housing finance market should be accomplished in several ways, leading to the sunset of the GSE charters at the end of the transition. One way would be successive reductions in the GSEs' conforming loan limits by 20 percent of the previous year's limits each year. These reductions would apply to conforming loan limits for both regular and high-cost areas. This should be done according to a published schedule so the private sector can plan for the investment of the necessary capital and create the necessary operational capacity. The private mortgage market would include banks, S&Ls, insurance companies, pension funds, other portfolio lenders and investors, mortgage bankers, mortgage insurance (MI) companies, and private securitization. Congress should make sure that it facilitates opportunities for additional financing alternatives, such as covered bonds.

Introduction

On February 11, 2011, the Departments of Treasury and Housing and Urban Development released the administration's report to Congress, titled *Reforming America's Housing Finance Market*. The paper outlined three options: a largely private system with government support only for low- and moderate-income housing (Option 1); a government-backed standby system, necessary only in the event of a housing market crash (Option 2); and a system for government backing of MBS issued by specially chartered companies (Option 3). No preference was expressed among them, and the report suggested deficiencies in all of them. However, the areas of agreement between the administration's approach and our initial white paper draft suggest that housing finance reform based largely on private-market principles is possible. For example, the administration's report accepts as a viable option:

- A privatized housing finance market as the primary source of mortgage credit, with private capital playing the predominant role in housing finance;
- Robust oversight in support of strict underwriting standards;
- Government assistance to low-income borrowers as a limited adjunct to a largely private financing system; and
- The need to wind down and privatize or eliminate Fannie Mae and Freddie Mac.

In effect, then, there is a rough agreement between our four principles and the administration's Option 1.

The administration recognizes the following advantages in a financing system that relies primarily on private financing:

> The strength of this option is that it would minimize distortions in capital allocation across sectors, reduce moral hazard in mortgage lending and drastically reduce direct taxpayer exposure to private lenders' losses. With less incentive to invest in housing, more capital will flow into other areas of the economy, potentially leading to more long-run economic growth and reducing the inflationary pressure on housing assets. Risk throughout the system may also be reduced, as private actors will not be as inclined to take on excessive risk without the assurance of a government guarantee behind them. And finally, direct taxpayer risk exposure to private losses in the mortgage market would be limited to the loans guaranteed by FHA [Federal Housing Administration] and other narrowly targeted government loan programs: no longer would taxpayers be at direct risk for guarantees covering most of the nation's mortgages.[4]

We share these conclusions. However, the administration sees the following deficiencies in a private-sector system:

> Though these are indeed significant benefits, this option has particularly acute costs in its potential impact on access to credit for many Americans. While FHA would continue to provide access to mortgage credit for low- and moderate-income Americans, the cost of mortgage credit for those who do not qualify for an FHA-insured loan—the majority of

[4] Departments of Treasury and HUD, *Reforming America's Housing Finance Market*, 27.

> borrowers—would likely increase. While mortgage rates are likely to rise somewhat under any responsible reform proposal, including the three outlined here, the effect could be larger under this option. In particular, it may be more difficult for many Americans to afford the traditional pre-payable, 30-year fixed-rate mortgage. Additionally, smaller lenders and community banks could have a difficult time competing for business outside of the FHA segment of the market, which may in turn impact access in the communities they have traditionally served more effectively than larger institutions.[5]

In testimony before the House Financial Services Committee, Treasury Secretary Timothy Geithner added that, if not addressed, Option 1 might result in mortgage-credit risk shifting from taxpayer liability under the GSE structure to taxpayer liability under the banking system, where some of the largest banks might be seen as too big to fail.

We believe there are sound responses that address the administration's concerns; we address them below in discussing our four principles.

[5] Ibid., 27–28.

I. The housing finance market—like other US industries and housing finance systems in most other developed countries—can and should principally function without any government financial support.

Our Principle I (combined with Principle III below) is virtually identical to the administration's Option 1, which proposes a "[p]rivatized system of housing finance with the government insurance role limited to FHA, USDA [US Department of Agriculture] and Department of Veterans' Affairs' [VA] assistance for narrowly targeted groups of borrowers." As noted above, the administration's support for a private system is based on the view that it eliminates taxpayer risk, reduces moral hazard and related risks throughout the housing finance system, and results in better allocation of resources by reducing overinvestment in housing. These are also the major reasons why we believe that substituting a private mortgage finance system for a government-backed system would be good policy.

Given the spectacular failures of US housing finance and the enormous cost to taxpayers of two massive bailouts in twenty years, the housing industry should be required to show why it needs government support again.[6] No other developed country provides anything that approaches the support for housing provided by the US government, and—as shown below—many of these other systems produce higher homeownership rates,[7] lower mortgage-interest rates (see table 1), and fewer losses when defaults occur (see table 2).

In the last twenty years, US taxpayers have had to pay for bailouts of two major elements of the housing finance system: the S&Ls in the late 1980s and early 1990s and the GSEs Fannie Mae and Freddie Mac beginning in 2008.[8] As two commentators described it, the S&L crisis of the 1980s and early 1990s "produced the greatest collapse of US financial institutions since the Great Depression. Over the 1986–1995 period, 1,043 thrifts with total assets of over $500 billion failed. The large number of failures overwhelmed the resources of the Federal Savings and Loan Insurance Corporation (FSLIC), so US taxpayers were required to back up the commitment extended to insured depositors of the failed institutions. As of December 31, 1999, the thrift crisis had cost taxpayers approximately $124 billion and the thrift industry another $29 billion, for an estimated total loss of approximately $153 billion."[9]

Today, taxpayers face even larger losses arising from the insolvency of Fannie Mae and Freddie Mac, both of which are now operating in conservatorships controlled by the government. Thus far, the Treasury has contributed approximately $150 billion to keep the two GSEs solvent, but the Federal Housing Finance Agency (FHFA), the GSEs' regulator, has estimated that their losses will fall between $221 billion and $363 billion. If housing prices continue to fall, many observers believe the total losses of the GSEs will eventually exceed $400 billion.

---

[6] In Principle III, we discuss how the government should proceed with respect to providing financial support for social policy purposes.

[7] *Testimony of Alex J. Pollock, Subcommittee on Security and International Trade and Finance, US Senate Committee on Banking, Housing, and Urban Affairs*, 111th Cong. (September 29, 2010).

[8] A government-induced overreliance on the freely prepayable thirty-year fixed-rate loan was instrumental in both bailouts.

[9] Timothy Curry and Lynn Shibut, "The Cost of the Savings and Loan Crisis: Truth and Consequences," *FDIC Banking Review*, December 2000, http://fcx.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf (accessed January 14, 2011).

The taxpayer losses in both the S&L and GSE debacles are related; as we will show, they are the inevitable result of extending government guarantees or subsidies to the housing finance industry. Before Congress considers any action on the future of housing finance, it should ask those who are pressing for government backing to explain why the taxpayers should be put at risk again.

Recent research by Dwight Jaffee, set out in table 1, documents that, notwithstanding the absence of government guarantees in most cases, many housing finance markets have achieved better outcomes than the US market along a number of critical dimensions.[10] For example, as table 1 shows, the United States has one of the highest mortgage debt levels (column 1) and among the highest mortgage interest rates (column 5) and spreads (column 6), yet is only average in owner occupancy rates (column 2). This is not an enviable record, and certainly not what American taxpayers deserve for all the losses they have covered to support the housing industry.

Table 1: The Performance of European Mortgage Markets in Comparison with the US Markets*
(Statistical measures computed with annual data by country for 1998–2008)

	(1)	(2)	(3)	(4)	(5)	(6)
	Mortgage to GDP Ratio (%)	Rate of Owner Occupancy (%)	Coefficient of Covariation Housing Starts (%)	Standard Deviation of House Price Inflation (%)	Mortgage Interest Rate Average Level (%)	Mortgage Interest Rate Average Spread** (%)
	2008	2008				
Western Europe						
Austria	25.3	57.0	8.3	2.6	5.12	0.66
Belgium	39.8	78.0	16.3	4.0	5.87	1.37
Denmark	95.3	54.0	40.8	6.1	5.96	1.41
Finland	47.5	59.0	11.0	3.4	4.50	0.05
France	35.9	57.4	16.4	5.5	4.93	0.53
Germany	46.1	43.2	30.1	0.8	5.27	0.97
Iceland	129.0	82.5	56.3	9.8	5.01	0.64
Ireland	80.0	74.5	35.8	11.5	4.69	0.22
Italy	19.8	80.0	47.0	3.1	5.25	0.64
Luxembourg	43.5	75.0	19.2	4.3	4.33	-0.16
Netherlands	99.1	57.0	10.2	5.5	5.17	0.77
Norway	55.7	77.0	21.1	5.0	6.54	1.61
Portugal	63.3	76.0	31.5	5.4	5.15	0.61
Spain	62.0	84.5	32.5	2.5	4.38	-0.09
Sweden	60.6	52.0	53.9	5.1	4.05	-0.49
UK	80.5	59.0	10.5	5.0	5.32	0.42
Euro Average	**61.5**	**66.6**	**27.6**	**5.0**	**5.10**	**0.57**

[10] Dwight M. Jaffee, "Reforming the US Mortgage Market through Private Market Incentives" (presentation, Federal Reserve Bank of St. Louis, November 17, 2010), http://research.stlouisfed.org/conferences/gse/Jaffee.pdf (accessed January 14, 2011).

US Average	**83.6**	**67.8**	**24.9**	**5.5**	**6.57**	**1.82**
US Rank (of 17)	**4th**	**9th**	**9th**	**4th**	**1st**	**1st**

Notes:
* Unless noted otherwise, the data are all from *European Mortgage Federation* (2008), an annual fact book that contains comprehensive mortgage and housing market data for 1998 to 2008 for the sixteen Western European countries and the United States.
** The mortgage interest rate spread equals the mortgage interest rate (column 5) relative to the government bond rate of each country derived from the International Financial Statistics of the International Monetary Fund.

Moreover, Jaffee's research also shows that when recent bubbles deflated in these other countries, the number of delinquencies and foreclosures was much lower than in the United States. All the countries in table 2 below had housing bubbles during the 2000s, some of them even larger than the one in the United States, but the outcomes in these countries were far better.

Table 2: Troubled Mortgages: Western Europe and the United States

	≥ Three-Month Arrears (%)	Impaired or Doubtful (%)	Foreclosures (%)	Year
Belgium	0.46			2009
Denmark	0.53			2009
France		0.93		2008
Ireland	3.32			2009
Italy		3.00		2008
Portugal	1.17			2009
Spain		3.04	0.24	2009
Sweden		1.00		2009
UK	2.44		0.19	2009
US All Loans	9.47		4.58	2009
US Prime	6.73		3.31	2009
US Subprime	25.26		15.58	2009

Source: European Mortgage Federation (2010) and Mortgage Bankers Association for US Data.

With this background, it is time to examine why the US housing finance system fails so consistently, even though since the 1930s it has been supported or backed by a growing phalanx of government agencies and enterprises (Federal Housing Administration, Fannie, Freddie, FSLIC, Federal Home Loan Banks or FHLBs, Ginnie Mae, VA, and the USDA). The reason, we believe, is that the US system fails *because of* its connection to the government. Government guarantees create moral hazard on two levels. First, by assuring the housing industry of a steady supply of underpriced funds, government support encourages overbuilding and speculation. The administration's report, as noted above, also cites the overinvestment in housing—calling it "distortions in capital allocation"—that results from government backing. In other industries, variations in the availability of funding suppress risk taking. In addition, by relieving investors of risk through a guarantee, government support makes it possible for mortgage originators to offer liberal lending terms such as zero or low down payment loans, loans without documentation, and

loans to credit-impaired borrowers.[11] As the administration noted in its report, a private mortgage finance system reduces risk. "Risk throughout the system may also be reduced," simply because of the fact that it is private: "private actors will not be as inclined to take on excessive risk without the assurance of a government guarantee behind them."[12]

However, the result of a government-backed system is not the stability the industry is seeking but a repetitive volatility—the growth and deflation of housing bubbles leading to credit crises such as (but smaller than) the one that occurred in 2008. It is because of excessive government intervention in the housing market that we now have both historically high borrower leverage (homeowner mortgage debt in relation to housing values) and a clearly inadequate amount of capital backing a debt market consisting of $10.6 trillion in first and second mortgages.[13]

Accordingly, for the six reasons outlined below, our first principle is that the housing finance market should be free of any government assistance in the future, other than for social policy reasons through FHA and other explicit and on-budget government programs.

1. The government cannot successfully price for risk. Many of the plans currently making the rounds in Washington depend on government backing at some level—usually as a guarantor of MBS issued by a financial intermediary. Two of the three options set out in the administration's report depend on government backing:

- Option 2: A largely privatized system of housing finance, with assistance for targeted groups of low-income borrowers from FHA and other government agencies and a guarantee mechanism to scale up government support during times of crisis in housing finance; and
- Option 3: A system of government reinsurance behind private issuers of MBS, coupled with FHA and other government assistance to low-income borrowers.

These plans are based on a fundamental error: that the government can act like an insurance company and set a correct price for the risk it is taking. The administration itself recognizes this problem:

> While the government can charge market participants an insurance premium for accepting that risk, pricing the risk can be difficult. If the government does not charge a fair price, it may encourage excessive risk-taking and increase the likelihood that the taxpayer will be forced to bear the cost of the government's losses. Political pressure to

[11] Additional commonly used provisions include negatively amortizing loans (option ARMs), ARMs as an affordability aid, liberal terms for cashing out equity, minimal right to recourse or enforcement of same, second mortgages (sometimes hidden), and loans to investors or speculators masquerading as prospective homeowners.
[12] Departments of Treasury and HUD, *Reforming America's Housing Finance Market*, 27.
[13] See Board of Governors of the Federal Reserve System, "Flow of Funds Accounts of the United States: Flows and Outstandings, Fourth Quarter 2010," March 10, 2011, www.federalreserve.gov/releases/z1/current/z1.pdf (accessed March 18, 2011). Fannie and Freddie, with no capital of their own, guarantee about 45 percent of all outstanding mortgages. The FHA, with about $5 billion in regulatory capital, guarantees another 10 percent, and commercial and savings banks own another 25 percent, which on a mark-to-market basis are substantially underwater. Most of the remainder is in the form of private MBS, also substantially underwater.

> lower the price of government support increases the odds that the government will misprice risk and put taxpayers at risk.[14]

Expanding on this summary, we see three reasons why the government cannot successfully price risks:

(i) Unlike an insurance company, the government has no profit incentive to price for risk, and because risk pricing can seem arbitrary and unrelated to current conditions, the government has many incentives to avoid the political controversy that risk pricing entails;

(ii) If the government actually attempted to set a price based on risk associated with any particular mortgage, it would be discriminating among its citizens, since some present greater risks than others; this would inevitably bring the risk-pricing project to a halt; and

(iii) Successful insurance systems require the buildup of substantial reserves during good times to pay claims during the inevitable bad times, but the government lacks the discipline and incentives to follow through. During the good times, the government comes under political pressure not to increase a reserve fund by continuing to collect fees or premiums.

The administration's report notes this tendency. "Political pressure to lower the price of government support increases the odds that the taxpayer will be forced to bear the cost of the government losses."[15] The argument is made that times are different, that the fund is large enough, or even that the industry is strapped for investment capital. These pressures cause the government to let it ride, to refrain from collecting the necessary fees or premiums. This has occurred with the National Flood Insurance Program,[16] the Pension Benefit Guaranty Corporation,[17] the FHA,[18] and the Federal Deposit Insurance Corporation (FDIC).

Recent FDIC experience is symptomatic of government's tendency to avoid collecting the necessary premiums. When the deposit-insurance system was reformed in 1991 in response to the failure of the FSLIC, Congress placed a limit on the size of the deposit-insurance fund that the FDIC could accumulate to meet the demands of a future crisis. Since 1996, the FDIC has been prohibited by law from charging premiums to well-capitalized and stable institutions. As a result, between 1996 and 2006, institutions representing 98 percent of deposits paid no deposit-insurance premiums. In 2009, FDIC chair Sheila Bair observed: "An important lesson going

---

[14] Departments of Treasury and HUD, *Reforming America's Housing Finance Market*, 26.
[15] Ibid., 26.
[16] "FEMA Administrator Craig Fugate says the debt results partly from Congress restraining insurance rates to encourage the purchase of coverage, which is required for property owners with a federally backed mortgage. . . . 'It is not run as a business,' Fugate said. Congress' Government Accountability Office said in April that the program is 'by design, not actuarially sound' because it has no cash reserves to pay for catastrophes such as Katrina and sets rates that 'do not reflect actual flood risk.' Raising insurance rates or limiting coverage is hard. 'The board of directors of this program is Congress,' Fugate said. 'They are very responsive to individuals who are being adversely affected.'" (Thomas Fink, "Huge Losses Put Federal Flood Insurance Plan in the Red," *USA Today*, August 26, 2010.)
[17] As of the end of FY2010, the Pension Benefit Guaranty Corporation (PBGC) reported a deficit of $23 billion. "In part, it is a result of the fact that the premiums PBGC charges are insufficient to pay for all the benefits that PBGC insures, and other factors." Pension Benefit Guaranty Corporation, "2010 PBGC Annual Report," www.pbgc.gov/about/ar2010.html (accessed January 14, 2011).
[18] Barclays Capital estimates that the FHA has drastically underpriced the risk of its guarantees and could face losses of up to $128 billion. Barclays, "US Housing Finance: No Silver Bullet," December 13, 2010.

forward is we need to be building up these funds in good times so you can draw down upon them in bad times."[19] Instead, once the bad times hit, the FDIC was forced to raise its premiums at the worst possible moment, thereby reinforcing the impact of the down cycle.

Principle II will discuss in greater detail the necessity for entities taking broad mortgage credit risk to build up thick contingency reserves through countercyclical reserving policies.

2. A government guarantee of MBS alone will have the same effect in creating taxpayer losses as any other guarantee. Several ideas recently advanced for government backing of the housing market, including the administration's Option 3, have suggested that the government's guarantee would extend only to MBS and not to the issuers of these securities. These plans would obligate the government to pick up losses only after the capital of an MBS issuer has been exhausted and would require the issuer to pay a fee to the government to cover the government's risks. This idea is presented as though it will prevent losses similar to those that have resulted from the operations of Fannie and Freddie—that the government's risks will be reduced and the likelihood of taxpayer losses will be minimized.

This is an illusion. As noted above, the fee to cover the taxpayers' risks cannot be effectively set by the government. Even if government had the incentives and capabilities to assess a proper fee, the assessment would be seen and attacked as an unfair tax on those who are using the government's services. For example, when the Office of Management and Budget suggested near the end of the Clinton administration that Fannie and Freddie pay a fee for the government's risk on its implicit backing of their obligations, the idea was immediately derided as a tax on homeownership, the administration was inundated with protests from the housing industry, and the proposal was promptly abandoned. Apart from whether a fee can be credibly established, it is fanciful to believe that any government will have the political fortitude to impose a fee that burdens homeowners or the housing industry because of the risks they pose to taxpayers.

Nor is the problem solved—as many of the supporters of these guarantee plans suggest—if the government is liable for losses on guaranteed MBS only after the issuer of the MBS has absorbed the first losses and exhausted its capital. It is true that in this case issuers will have an incentive to be cautious about risk taking, but the government guarantee eliminates an important element of market discipline—the risk aversion of investors. These securities will undoubtedly be sold worldwide as US government credit. The existence of a government guarantee will mean that no MBS buyer needs to be concerned about the quality of the underlying loans or the financial stability of the issuer. This is exactly analogous to the effect of deposit insurance on risk taking by banks. As is well known, deposit insurance permits bank depositors to ignore the risks a bank is taking—the principal reason that so many banks fail. As in the case of deposit insurance, government backing of MBS will eliminate investor concerns about both the financial stability of the issuer and the quality of the mortgages underlying the MBS. This will introduce destructive moral hazard into the housing finance market, allowing the expansion of risks through the securitization of very low-quality mortgages.

---

[19] Center on Federal Financial Institutions, "Federal Deposit Insurance Corporation," August 10, 2005, www.coffi.org/pubs/Summaries/FDIC%20Summary.pdf (accessed January 14, 2011). See also Congressional Budget Office, "Modifying Federal Deposit Insurance," May 9, 2005, "Currently, 93 percent of FDIC-insured institutions, which hold 98 percent of insured deposits, pay nothing for deposit insurance."

A companion risk will also spontaneously arise: these entities, chartered and regulated by the government, and carrying out a government mission, will inevitably be seen as functioning under government sponsorship. As such, they will be imbued with an implicit guarantee and might even be expected to perform other governmental functions such as supporting affordable housing. As we saw with Fannie and Freddie, both elements almost always accompany the performance of a government mission.

The protection of the government and the taxpayers in these cases will then supposedly come through regulation—another prescription of the advocates of government backing for MBS. They argue that regulation of the issuer is necessary to ensure that it has sufficient capital to cover the risks it is taking and thus to protect the government and the taxpayers from loss. But experience with bank regulation has shown that it does not prevent excessive risk taking and does not ensure sufficient capital to cover risks. Moreover, regulators are frequently unable to determine the financial condition of a regulated entity until it is too late. In these cases, the taxpayers will once again end up holding the bag.

3. Government backing distorts prices, resource allocation, and competition. The fact that the government cannot price for risk should be an important clue about the distorting effect its guarantee will have on competition. For the reasons outlined above, the government's charge for supporting one sector of the housing market will be lower than what the actual risk would demand, so its backing will operate as a subsidy for the sector of the housing market it is actually covering. For an equivalent risk, all other things being equal, the government-guaranteed mortgage will always be cheaper than the privately backed mortgage. This simply means that the taxpayers are providing a benefit to the borrower and the lender. The real costs to society appear later. As we will see, however, with appropriate reforms, it is possible that private-sector mortgage costs will reach the same level as those with government backing, while still protecting the taxpayers against loss.

In the housing finance system as it exists today, however, private competitors will be driven out of any sector of the market where the government guarantee is offered. Moreover, political pressures will make it attractive to extend the benefits of the lower-cost government-backed mortgage to more constituents, expanding the size of the sector that will be covered by the guarantee, and thus gradually extending the government's obligations to cover a larger sector of the market.

We have seen this before. With Fannie and Freddie able to borrow at much lower rates than others because of their implicit government backing, they drove all potential private competition out of the secondary market for fixed-rate prime loans at or below the conforming loan limit, and most mortgage originators preferred to direct their production to Fannie and Freddie, which could offer them the best pricing. Political pressure—to allow more members of the public to get the benefits of the taxpayer subsidy—also extended the subsidized market into an area that had previously been reserved for private activity. Thus, when Congress enacted the Housing and Economic Recovery Act of 2008,[20] it raised the conforming loan limit for Fannie and Freddie so buyers of million-dollar homes would have access to the benefits of the taxpayer subsidy provided free to Fannie and Freddie. In 1992, Congress pushed the subsidy in the other direction, requiring Fannie and Freddie to make what were called "affordable housing" loans to

[20] Housing and Economic Recovery Act of 2008 (HERA), Pub. L. No. 110-289 (July 30, 2008).

borrowers at or below the median income in the areas where they lived. Accordingly, if a government guarantee is again introduced into the housing sector, it will gradually grow to squeeze out private nongovernmental financing of mortgages. In other words, it is unlikely that Congress, once it allows any portion of the housing market to be covered by a government guarantee, will be able to place any effective limits on the extent of the taxpayers' risks.

4. It is a myth that only a government guarantee can make a thirty-year fixed-rate mortgage available. The administration's report suggests that without a government role in the housing market the thirty-year fixed-rate mortgage will not be available to American homebuyers. On its face, this is not true, since anyone can go to the Internet and find lenders offering jumbo fixed-rate thirty-year loans—which, by definition, have no government backing. It is true that, at this point, a thirty-year fixed-rate mortgage is somewhat more expensive than a government-backed thirty-year fixed-rate mortgage, since the lender is taking a longer-term risk on interest rates, but the lower cost of the government mortgage simply means that the taxpayers—as well as all other mortgage borrowers who are not taking thirty-year fixed-rate mortgages—are providing a subsidy to the person who wants a government-backed mortgage with these terms.

History has shown—and simple economics would anticipate—that a government subsidy for a thirty-year fixed-rate mortgage is not good policy. The subsidy causes most borrowers to choose the thirty-year loan, since in general it offers a fixed, low monthly payment with a government-subsidized "free" prepayment option. Supporters, including the administration in its Option 3, point to the apparent stability it provides to borrowers. This "stability," however, carries with it several serious deficiencies. A thirty-year loan amortizes slowly, keeping the homeowner's equity low and debt level high for a good portion of the loan period. If the home is sold after seven years (the average duration of occupancy), the homeowner has not accumulated much equity.[21] In addition, the "free" prepayment option encourages equity withdrawal through serial refinancing.

For these reasons, it is peculiar that the proponents of government backing are never asked to explain why the taxpayers and other mortgage borrowers should be subsidizing a thirty-year fixed-rate mortgage. This is not to say that this mortgage should not be available, but only that homeowners who want such a loan should not expect the taxpayers to subsidize its availability. In today's market, it is available at a slightly higher cost without a taxpayer subsidy.

There is an additional benefit to a market without government guarantees. Borrowers would have a variety of solidly underwritten loan choices.[22] What the interest rates would actually be depends, of course, on monetary and fiscal policy in the United States. As an example of what the loan menu might look like, we take a historically typical spread of about 2 percent over the ten-year Treasury rate for a thirty-year fixed-rate jumbo loan and assume a 4 percent yield on the ten-year Treasury note. (From 2002 to 2008, the average spread on a thirty-year fixed-rate jumbo loan was a little under 2 percent, and the average ten-year Treasury yield was about 4 percent.) This gives a base price of 6 percent for a thirty-year, fixed-rate, freely

[21] See, for example, Peter J. Wallison, "What's So Special about the 30-Year Mortgage?" *Wall Street Journal*, February 1, 2011, www.aei.org/article/103092.

[22] Loan-performance data demonstrate that loans with a fixed-rate period of seven years, ten years, and thirty years (all with a thirty-year amortization) have similar default experiences.

prepayable jumbo mortgage. A loan with the same structure, but guaranteed by Fannie or Freddie, would be slightly less costly because of the government subsidy. A 2005 study estimates the differential at about thirty basis points;[23] a Federal Reserve study in 2005, however, estimates the differential at seven basis points.[24] Whichever is correct, the benefit associated with the government subsidy is far outweighed by the detriments a government role carries with it.

In the list below, we use the 6 percent jumbo fixed-rate mortgage as a benchmark to estimate the range of probable rates for a series of mortgages with different characteristics that would be available in a nongovernment market. In this market, we would expect some borrowers to select a thirty-year fixed-rate freely prepayable loan at an interest rate of 6 percent with others selecting a different option based on their needs and cost. These options offer a lower rate for a shorter maturity and/or a lower rate if borrowers choose a loan with a prepayment fee:

6.00%	thirty-year fixed-rate term with no prepayment fee
5.625%	thirty-year fixed-rate term with a 3-2-1 prepayment fee[25]
5.375%	thirty-year amortization with fifteen-year fixed-rate term and a 3-2-1 prepayment fee
5.375%	fifteen-year fixed-rate term with no prepayment fee
5.125%	fifteen-year fixed-rate term with a 3-2-1 prepayment fee
5.00%	seven-year adjustable-rate mortgage (ARM) with thirty-year amortization underwritten at fully indexed seven-year rate with no prepayment fee
4.75%	seven-year ARM with thirty-year amortization underwritten at fully indexed seven-year rate with a 3-2-1 prepayment fee

5. Should the government guarantee a steady flow of credit for housing? One of the key arguments for government support in housing finance is that only with such support can a steady flow of credit to the housing market be assured. Originally, this argument was based on past experience, which is no longer relevant. Government regulation of interest rates, specifically the old Regulation Q deposit-rate ceilings, caused frequent periods when banks and S&Ls could not offer competitive rates for savings. The result was that mortgage lending, housing construction, and home sales were severely impaired. After Regulation Q was eliminated, this ceased to be a problem.

Now the argument has changed; in the event of a financial crisis, it is said, the government should make sure housing gets credit and funding in preference to manufacturing, commerce, consumer credit, or anything else. As the administration noted in its report, this effect

[23] Anthony B. Sanders, "Measuring the Benefits of Fannie Mae and Freddie Mac to Consumers: Between De Minimis and Small?" July 2005, http://fic.wharton.upenn.edu/fic/papers/05/0536.pdf (accessed January 14, 2011).
[24] Wayne Passmore, Shane M. Sherlund, and Gillian Burgess, "The Effect of the Housing Government Sponsored Enterprises on Mortgage Rates," Federal Reserve Board Finance and Economics Discussion Series, January 2005, www.federalreserve.gov/pubs/feds/2005/200506/200506abs.html (accessed March 18, 2011).
[25] A prepayment fee of 3 percent in year one, 2 percent in year two, 1 percent in year three, and zero percent thereafter.

is not good policy: "The increased flow of capital into the mortgage market [encouraged by a government guarantee] could draw capital away from potentially more productive sectors of the economy and could artificially inflate the value of housing assets."[26] It is hard to defend this preference for housing on economic grounds. Indeed, most of the time, the involvement of the government in housing finance creates the danger of excess supply of credit to housing relative to all other sectors. The administration again sees the issue the same way: "With less incentive to invest in housing, more capital will flow into other areas of the economy, potentially leading to more long-run economic growth and reducing inflationary pressure on housing assets."[27]

Government involvement helps encourage homebuilders to overbuild, lenders to overlend, and borrowers to overborrow. In other words, it is a source of moral hazard. If participants in the housing market are insulated from changes in the market, they will take more risks and be less prudent in their investment decisions. The possibility that financing for housing could be subject to disruption or financing restrictions is, of course, one of the risks the housing industry fears, but that fear will reduce the overbuilding and excessive leverage that have caused volatility and repeated housing bubbles in the past. Other industries, of course, manage perfectly well to survive fluctuations in the availability or cost of funding. This issue will be discussed further under Principle II.

A related and frequently cited reason for a government role in housing finance is what is known as TBA—or "To Be Announced" funding. TBA permits homebuyers to "lock in" an interest rate with a bank or other financing source when they agree to purchase a home. This can be replicated in a fully private market if the originating or funding bank uses a hedging strategy to ensure that when the funds are called on, it will be able to supply them at the interest rate originally agreed with the homebuyer, even if market rates have changed. The bank's hedging strategy has a cost, and it will be included in the rate that the bank quotes for the loan. The additional hedging cost is not a major factor in the interest rate, so there is no reason for the government to be involved in this or for the taxpayers to support a whole system of government enterprises to make sure it is available.[28] Under Principle II, we outline why we expect this activity to reemerge in a private MBS market without the taxpayer risks associated with a government guarantee.

6. Is a government guarantee necessary to sell MBS to institutional investors and others? Finally, there is the argument—sometimes explicit and otherwise implicit—that institutional investors will only buy US mortgages, or MBS backed by US mortgages, if they are supported by a government guarantee. This is probably the key reason that government backing of housing finance continues to enjoy support in Washington. It would certainly be a weighty argument if the quality of the mortgages were generally low; in that case, delinquency rates and defaults would be high, and the risks of investment in mortgages or MBS could well be unacceptable for institutional investors such as insurance companies, pension funds, mutual funds, and others. Even in that case, it is questionable whether the taxpayers should support a housing market in which mortgage quality was generally low. But as discussed below, there is no

---

[26] Departments of Treasury and HUD, *Reforming America's Housing Finance Market*, 30.
[27] Ibid., 27.
[28] See Kevin Villani, "The Future of US Housing Finance: Why a Competitive Market Oriented Housing Finance System Is Still Best," November, 2010, http://chicagoboyz.net/blogfiles/TheFutureVIL.pdf (accessed January 14, 2011).

reason why mortgages have to be low quality, especially the mortgages allowed into the securitization market.

Until the introduction of the affordable-housing requirements for Fannie and Freddie, the GSEs maintained high underwriting standards and never suffered substantial losses on the mortgages they held or guaranteed. Indeed, their charter required them to purchase only prime loans. Section 1719 of Fannie's charter stated: "[T]he operations of the corporation . . . shall be confined . . . to mortgages which are deemed by the corporation to be of such quality, type, and class as to meet, generally, the *purchase standards imposed by private institutional mortgage investors*."[29]

Even in the current crisis, the GSEs' delinquency rates among *prime* mortgages have been less than 3 percent, while their delinquency rates on the subprime and Alt-A loans they acquired largely because of the affordable-housing goals have ranged from 13.3 to 17.3 percent.[30] Accordingly, the key to a successful mortgage market is not a government guarantee—which will inevitably cause serious losses to the taxpayers—but ensuring that the mortgages that are sent into the securitization market are of prime quality.

Under Principle II, we will show that by implementing policies that ensure good-quality mortgages, it is possible to create a stable housing finance system that attracts institutional investors without the need for any government involvement.

[29] Cornell University Law School, "US Code: § 1719. Secondary Market Operations," www.law.cornell.edu/uscode/html/uscode12/usc_sec_12_00001719----000-.html (accessed March 18, 2011). Emphasis added.

[30] Edward J. Pinto, "Government Housing Policies in the Lead-Up to the Financial Crisis: A Forensic Study," November 4, 2010, chart 53, www.aei.org/docLib/Government-Housing-Policies-Financial-Crisis-Pinto-102110.pdf.

II. Ensuring mortgage quality and fostering the accumulation of adequate capital behind housing risk can create a robust housing investment market without a government guarantee.

Many observers have noted that when Congress adopted the Dodd-Frank Act (DFA) it failed to address the real causes of the financial crisis—the government housing policies that enhanced the size and duration of the housing bubble and encouraged the creation of 27 million subprime and Alt-A loans. These weak loans fed the growth of an unprecedented housing bubble, and as the bubble grew it suppressed the delinquencies and defaults that usually signal to investors that acquiring low-quality mortgages entails substantial risks. When the bubble finally began to deflate, these weak and high-risk loans began to default at unprecedented rates, weakening financial institutions in the United States and around the world that were holding either these mortgages or the MBS they backed. If Congress had properly diagnosed the causes of the financial crisis before it began drafting the enormously complicated and unnecessary DFA, it would instead have enacted legislation to correct the deficiencies in government policy and the mortgage market that were the source of the bubble, the unprecedented number of weak and high-risk mortgages in the US financial system, the financial crisis of 2008, and the serious recession that followed.

Generally, economic theory suggests that regulation is only appropriate when there is a market failure. The development of housing bubbles, and their tendency to suppress the normal signals associated with risk, demonstrates that conventional market-control mechanisms—key elements such as market discipline—are not capable of preventing the downward slide in mortgage underwriting standards as a bubble develops. This is exactly what happened before the onset of the financial crisis. By the early 2000s, government investment in subprime and other low-quality mortgages had built a bubble that was almost five years old and still growing.[31] With delinquencies and defaults suppressed, subprime lending seemed highly profitable. By 2002, potential investors around the world could see that high yields were available on MBS based on pools of subprime loans with relatively few losses. In other words, these securities appeared to have high risk-adjusted returns. This accounts for the extraordinary growth of the private subprime MBS market—a market that had never existed before—beginning in 2002 and extending until the collapse of the bubble in 2007.

It is typical to see increasing leverage (and expanding demand) during the growth portion of the cycle. Homeowners seek mortgages that will enable them to buy larger homes with nearly the same monthly payment. Increased borrower leverage results from reduced down-payment and debt-to-income requirements, increased reliance on so-called affordability products such as adjustable-rate and interest-only loans, and extended eligibility for loans among borrowers with impaired credit. As prices outpace incomes, nontraditional lending expands to meet the new or greater affordability gap. Lenders accede to these requests because they have become excessively optimistic and believe that rising home prices will continue to rise and limit their risk

[31] Josh Rosner, "Housing in the New Millennium: A Home without Equity Is Just a Rental with Debt" (presentation, 2002 Mid-Year Meeting, American Real Estate and Urban Economics Association, National Association of Home Builders, Washington, DC, May 28–29, 2002), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1162456 (accessed March 18, 2011). Rosner noted that government efforts to reduce down payments and promote housing targeted to low-income borrowers had already been a major catalyst to the nineties housing boom.

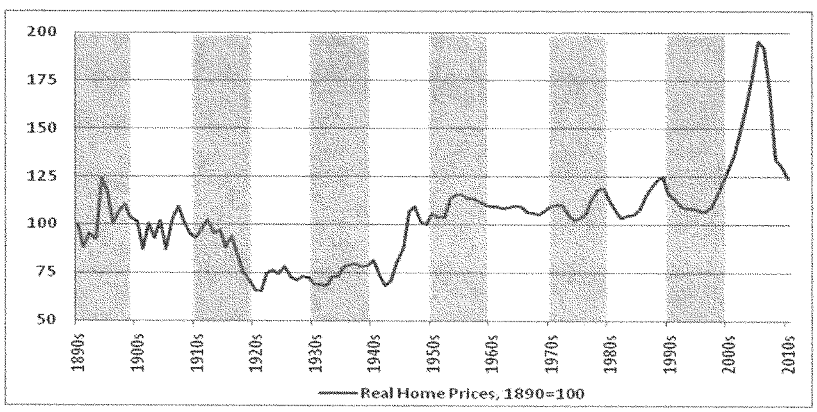
of loss. Indeed, increasing home prices have suppressed the delinquencies and defaults that typically signal to lenders and investors that the risks are rising. This may keep the "up" portion of the cycle growing, but it weakens the underlying stability of the market, adding particular vulnerability for the most recent borrowers. We have enough experience with housing bubbles now to realize that they are artifacts of human nature and will occur to some extent no matter what we do. However, we can reduce their frequency and the damage when they deflate by ensuring the maintenance of sound credit standards.

One of the characteristics of bubbles is that they are difficult to recognize while you are inside, but very easy to recognize in hindsight. Also, the fact that they occur in many assets other than mortgages suggests that they reflect the human tendency to explain away unusual circumstances on the ground as "this time it's different." However, real estate bubbles have been particularly harmful to the US economy when they collapse; the prescriptions in this paper—while they will not entirely prevent bubbles—will go a long way toward making them less likely, less widespread, and smaller.

Since the 1920s, there have been at least four real estate booms followed by two serious corrections and two busts.[32] The boom periods were the 1920s (17 percent real home-price increase), the late 1970s (16 percent real home-price increase), the late 1980s (20 percent real home-price increase), and 1997–2006 (85 percent real home-price increase).

Figure 1 shows the trend of real home prices since 1890. The real-price trend clearly shows the recent bubbles in 1979, 1989, and 1997–2006.

Figure 1: Real Home Prices, 1890–2010[33]



[32] The real-price boom that occurred over 1942–1955 (72 percent real-price growth) is excluded given the unusual circumstances relating to World War II and the postwar baby boom. By 1955, real prices had recovered to their late 1890s to early 1900s trend line.

[33] Compiled from Robert Shiller's updated historical housing market data used in his book, *Irrational Exuberance* (Princeton University Press, 2000; Broadway Books, 2001; 2nd edition, 2005). Data available at www.econ.yale.edu/~shiller/data.htm.

There are common elements in these episodes: government support for increasing homeownership, widespread use of second mortgages to reduce down payments, excessive leverage, reliance on adjustable-rate and negatively amortizing loans, higher debt-to-income ratios, and extensive use of low- and no-doc loans. This suggests that with limited regulatory intervention, particularly by ensuring mortgage quality, the effects of bubbles in the United States can be mitigated. That is, bubbles will occur, in housing as in other fields, but when they deflate, they will not be as destructive as in the past. If we can address these common elements through regulation focused on credit quality, we can accomplish what the DFA will fail to do: prevent another financial crisis arising from a proliferation of weak mortgages.

Accordingly, beyond removing government subsidies and guarantees from housing finance, much can be accomplished simply by adopting seven policies for the regulation of housing finance in the future:

1. Ensure that a high preponderance of loans are prime. We should adopt policies to ensure that a high preponderance of all mortgages in the future will be of prime or high quality. This should not be difficult, nor will it unreasonably limit the availability of mortgages. According to a Federal Reserve study, over 70 percent of all individuals with credit records in the United States (not just all homeowners with credit records) have FICO credit scores that are 660 or above—the foundation for a prime loan. Well over a majority (58 percent) have credit scores above 700.[34] In both 1989[35] and 2010,[36] 87 percent of borrowers taking out a mortgage loan had a FICO score of 660 or greater. In 1991, the great majority of conventional loans (defined as being Fannie eligible, other than by loan size) had the following characteristics:

- 98 percent were loans on properties occupied as a primary or secondary residence.[37]
- 94 percent were loans with a loan-to-value ratio (LTV) of 90 percent or less.[38]
- 98 percent were to borrowers with one or no mortgage late payments at origination and 85 percent had two or fewer nonmortgage late payments at origination.[39]
- 90 percent were loans with housing and total debt-to-income ratios of less than 33 percent and 38 percent, respectively.[40]
- All loans had to be underwritten based upon verified income, assets, and credit.[41]

[34] Board of Governors of the Federal Reserve System, "Report to Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit," August 2007, www.federalreserve.gov/boarddocs/rptcongress/creditscore/creditscore.pdf (accessed March 18, 2011).
[35] Letter in author's file dated October 30, 1989, to Ed Pinto from Equifax enclosing odds charts for new real estate accounts developed by Fair, Isaac Company (FICO).
[36] FICO presentation at American Securitization Forum 2011, "Consumer Metrics and Evaluation," February 6, 2011.
[37] Data from Fannie Mae's random-sample review covering single-family acquisitions for the period October 1988–January 1992, dated March 10, 1992. Document contained in the authors' files.
[38] Ibid.
[39] Ibid.
[40] Ibid.
[41] Fannie stopped acquiring low-doc or no-doc loans in 1990. Freddie followed suit in 1991. See "Haste Makes . . . Quick Home Loans Have Quickly Become Another Banking Mess," *Wall Street Journal*, July 5, 1991.

Nevertheless, to ensure the continuing quality of mortgage loans, it will be necessary to define the characteristics of loans with relatively low default rates. The characteristics of a prime loan do not generally change over time, an experience confirmed over long periods in the United States and other developed countries. Historically, prime fixed-rate loans had a default rate of less than one in one hundred loans,[42] prime loans with an LTV of 81–90 percent have had a default rate of about 2.5 in one hundred loans, and loans with private MI (both fixed rate and ARMs and LTVs up to 97 percent) have experienced a default rate of about five in one hundred loans.[43] Loans with FHA insurance have experienced a default rate in excess of ten in one hundred loans.[44] In appendix 1, we provide the details for defining a prime loan.

2. Correspondingly, nonprime loans should be a relatively small percentage of all loans. Given that the market share of nonprime loans tends to grow as a boom develops, these loans—characterized by low or no down payments, increased debt ratios, impaired credit, reduced loan amortization, loans to investors or speculators, and other underwriting standards not present in prime loans—must be limited to a relatively small percentage of all mortgage loans. It is the accumulation of these loans that first buoy, then capsize, a regional or national housing market. Nonprime loans are unsuitable to serve as collateral for private MBS and covered bonds.[45]

3. Allow securitization only for prime loans. The DFA proposes a cumbersome and possibly unworkable system of risk retentions in cases where loan securitizations do not involve a Qualified Residential Mortgage (QRM), which is to be defined by regulation. In light of the earlier discussion of bubbles—in which we described the relationship between declining underwriting standards and the growth of bubbles—it makes more sense simply to require that the securitization market be used only for prime loans. That would do away with retentions and the need for a QRM. Nonprime loans could then be held in the portfolios of banks, insurance companies, pension funds, and other financial institutions, but only if the market transparency described in number six below allows investors, rating agencies, and others to understand how many of these nonprime loans are outstanding.

4. A potentially valuable structure would require MI for securitized loans with LTV ratios higher than 60 percent. Despite their underlying quality, prime mortgages with LTVs higher than 60 percent require some form of credit enhancement to be attractive to investors. Below is a Fannie Mae table showing the loan-level pricing adjustment (LLPA) fees that Fannie now adds to the mortgages it acquires.[46] These are a form of self-insurance; the table shows fees applied in varying amounts to virtually all loans with LTVs greater than 60 percent, but not to loans with LTVs below that level. The table also shows that as FICO scores rise, loan-level fees decline for loans with equivalent LTVs.[47]

---

[42] Derived from Freddie Mac data.
[43] Standard & Poor's Ratings Direct Report, December 27, 2008.
[44] FHA's 2010 and 2003 Actuarial Studies.
[45] Ginnie Mae securities backed by government agency loans would be exempt.
[46] There are some miscellaneous loan-level fees not shown on this chart, virtually all of which are applied to loans with an LTV greater than 60 percent.
[47] See Fannie Mae, "Loan-Level Price Adjustment (LLPA) Matrix and Adverse Market Delivery Charge (AMDC) Information," December 23, 2010, https://www.efanniemae.com/sf/refmaterials/llpa/pdf/llpamatrix.pdf (accessed

Table 2: All Eligible Mortgages (Excluding MCM): LLPA by Credit Score/LTV									
PRODUCT FEATURE	LLPAs by LTV Range								
	≤ 60.00%	60.01 – 70.00%	70.01 – 75.00%	75.01 – 80.00%	80.01 – 85.00%	85.01 – 90.00%	90.01 – 95.00%	95.01 – 97.00%	SFC
Representative Credit Score	Applicable for all mortgages with greater than 15-year terms For whole loans purchased on or after April 1, 2011, and loans delivered into MBS with issue dates on or after April 1, 2011. (LLPA changes highlighted in bold)								
≥ 740	-0.250%	0.000%	0.000%	0.250%	0.250%	0.250%	0.250%	0.250%	N/A
720 – 739	-0.250%	0.000%	0.250%	0.500%	0.500%	0.500%	0.500%	0.500%	N/A
700 – 719	-0.250%	0.500%	0.750%	1.000%	1.000%	1.000%	1.000%	1.000%	N/A
680 – 699	0.000%	0.500%	1.250%	1.750%	1.500%	1.250%	1.250%	1.000%	N/A
660 – 679	0.000%	1.000%	2.000%	2.500%	2.750%	2.250%	2.250%	1.750%	N/A

These are the requirements for what one would call "normal loss experience" on prime mortgages. Additional MI or other credit enhancement would be necessary to address catastrophic conditions, such as a housing price decline of as much as 35 percent. Fitch Ratings, for example, proposed in a recent report that each loan have sufficient loss protection to experience a severe stress event as represented by a 35 percent price decline, again focusing on the risks associated with loans with an LTV above 60 percent.[48]

Today, Fannie and Freddie are required by statute to have MI coverage (or other third-party credit enhancement) for all loans where the LTV is higher than 80 percent. As noted above, since 2008, Fannie Mae and Freddie Mac have been applying LLPAs to most mortgages with LTVs above 60 percent to cover their additional risks beyond the required insurance coverage. Because of their implicit government backing, they can avoid any further credit enhancement in order to sell their MBS.

The private securitizations that we envision could use other forms of credit enhancement—a combination of subordinated tranches and private MI—to achieve an AAA rating for the MBS. In the traditional private securitization, the AAA-rated securities are credit enhanced largely by subordination; the lower tranches in a securitized pool (say, BBB-rated) are generally not entitled to any payment until the AAA tranches have been paid in full. The size or thickness of the subordinated tranches provides the assurance that investors in AAA-rated securities need; the riskier the pool, the larger the subordinated tranches have to be. In other words, the existence of a thick subordinated layer can make the pool a reliable counterparty for an institutional investor.

However, a thick subordinated layer also adds to the cost of credit enhancement. In addition, the lower tranches in a securitized pool of mortgages are only available to support the AAA securities based on that pool. By adding private MI, we can lower the cost of credit enhancement. This is because the companies that issue MI coverage are required by insurance regulators to establish capital reserves that are available to cover losses on all covered mortgages

March 18, 2010). LLPAs take into account specific credit risks associated with down payment size and credit score. These types of risks may be determined on an actuarial basis and are generally uncorrelated.

[48] Fitch Ratings, "US Prime RMBS Loan Loss Model Criteria: Exposure Draft," February 1, 2011. A severe stress event is usually associated with an economic downturn such as a deep recession with its attendant increased unemployment, which puts stress on incomes, employment, and home prices. This type of risk may not be actuarially determined; instead stress tests are based on worst-case depression scenarios. While these risks result in losses that are generally correlated; the impact can be kept manageable with sound underwriting and the accumulation of substantial reserves able to withstand such a level of stress.

in multiple pools and book years. MI is thus a more efficient—and less costly—form of credit enhancement than added thickness to the subordinated layers.

MI also has important advantages for the coverage of losses that occur in catastrophic conditions. Under current insurance regulation, 50 percent of premium revenues must be transferred to required reserves, and they are intended to be used only for catastrophic conditions. Normal claim payouts along with normal expenses have to be handled out of the remaining 50 percent. This reserve level has been in force since the establishment of the modern MI business in 1957, following the industry's collapse during the Great Depression and its reorganization according to new principles.[49] These principles, including the establishment of required reserves, enabled virtually the entire MI industry to survive the recent financial crisis while meeting its coverage obligations. Over time, the buildup of these required reserves will fully protect the holders of privately issued MBS against the possibility of another financial crisis.

The specific elements of the MI coverage and insurer standards that we envision are outlined in appendix 1 but may be summarized as follows. The MI firms will issue coverage only for prime loans as defined in appendix 1. They will be state-regulated monoline companies—operating independently of originators, issuers, or others; maintaining minimum risk-to-capital ratios;[50] and allocating 50 percent of gross premiums to catastrophic contingency reserves (required by state insurance regulations to be held for ten years). Over time, these reserves will likely lead to even lower risk-to-capital ratios.

Accordingly, under our proposed private financing system, prime mortgages with LTVs higher than 60 percent would be credit enhanced with MI down to the 60 percent level. This would apply to any loan with a term of sixteen to thirty years and an LTV greater than 60 percent. Fully amortizing loans with a term of fifteen years or less perform markedly better than loans with longer terms; therefore, these loans will require MI only if they have an LTV greater than 80 percent, and then only down to 70 percent.

---

[49] Thomas Herzog, "History of Mortgage Finance With an Emphasis on Mortgage Insurance", 2009, http://www.soa.org/library/monographs/finance/housing-wealth/2009/september/mono-2009-mfi09-herzog-history.pdf

[50] Current regulations require an MI company to maintain a twenty-five-to-one risk-to-capital ratio, regardless of risk profile. The industry entered the crisis with a much lower risk-to-capital ratio of 13.9 to 1, due to the accumulation of statutorily required catastrophic reserves. When the housing crisis hit in late 2007, 64 percent of MI companies' primary risk in force had an LTV of greater than 90 percent and 96 percent had an LTV of greater than 85 percent. It is now estimated that the industry will suffer a projected conditional claim rate of 17 percent. This severe claims experience represented a loss event at the ninety-sixth percentile, meaning that out of all possible loss scenarios, this event was worse than 95 percent of them. An MI rated AA is expected to survive 99.5 percent of all such loss scenarios. This explains why MI companies have been able to pay virtually all eligible claims, with only the smallest MI company with about an 7 percent share being in run-off and still likely to pay an estimated 70 percent of its claims. We propose that MI companies be restricted to prime loans only, as defined in appendix 1. After the anticipated five-year GSE wind-down period, it is expected that 80 percent of the new risk in force will have an LTV of 80 percent or less. With initial risk-to-capital ratios ranging from thirteen to one for prime 90 percent LTV loans to forty-one to one for prime 65 percent LTV loans, these initial capital levels are sufficient to cover a stress event well beyond the severity of the one we have just experienced. For comparison purposes, Fannie had an overall risk-to-capital ratio requirement of 220 to 1 for its MBS guaranty business, with much of its capital invested in mortgages and housing tax credits.

The catastrophic reserve is designed to build up over a ten-year cycle. Before that buildup, we believe that the risk-to-capital ratios we recommend will be more than sufficient to withstand the level of stress experienced during the recent financial crisis. This will make the MI industry a reliable counterparty for institutional investors. At the same time, the use of risk-adjusted risk-to-capital ratios will have countercyclical effects; an upward trend in high LTV lending will require larger amounts of capital. After about eight years, the combination of normal capital along with the accumulated catastrophic reserve should be adequate to allow an MI company's risk-to-capital ratio to meet the AAA standard. This higher level of capital will allow for the continued extension of credit on a prudent basis during times of stress.

We have consulted with members of the MI industry and have been advised that if the mortgages they insure are prime mortgages as defined in appendix 1, they can maintain the risk-to-capital ratio scale noted in appendix 1, allocate 50 percent of their premium revenue to reserves as required, and still operate profitably. Accordingly, once it becomes clear that the MI industry will be participating in the private securitization process we envision, the industry should have no trouble recapitalizing itself to achieve an AA rating. Indeed, new companies are already entering the MI industry—most recently Essent US Holdings, a venture of Goldman Sachs, JP Morgan Chase, and two reinsurers, among others, with initial capitalization of $500 million.[51]

In our consultation with members of the MI and securitization industry, we were advised that the combined cost of MI for the coverages specified above, along with required subordinated (risk-bearing) tranches, would initially permit private MBS to fund a freely prepayable thirty-year fixed-rate prime loan with an all-in annual cost about twenty-five to forty basis points higher than Fannie's current cost for the same instrument. In this connection, we note that the program outlined by the Center for American Progress, which requires an explicit federal guarantee, would nevertheless result in a rate increase of about forty basis points.[52] If the administration's proposal to increase Fannie and Freddie's guarantee fees resulted, as expected, in a fifteen-basis-point higher fee, the indicated rate under the nongovernment MBS program would likely be only ten to twenty-five basis points higher than Fannie's new rate. Over time, one might expect the spread between the private MBS execution and a Fannie execution to narrow as the MI industry's catastrophic reserves build and demand increases for these securities.

MI companies reserve the right to rescind coverage on a finding of fraud. During the recent financial crisis period, when a growing bubble and declining underwriting, led to rampant mortgage fraud, misrepresentation, and appraisal errors,[53] the MI industry rescinded large

[51] James McGee, "Essent CEO Says Time Is Very Good to Start a Mortgage Insurer," Bloomberg.com, February 18, 2011, www.bloomberg.com/apps/news?pid=newsarchive&sid=axq7O3CVgCxs (accessed March 22, 2011).
[52] Mortgage Finance Working Group, *A Responsible Market for Housing Finance* (Washington, DC: Center for American Progress, January 27, 2011), www.americanprogress.org/issues/2011/01/responsible_market.html (accessed March 22, 2011).
[53] See Financial Crisis Inquiry Commission, *Financial Crisis Report*, xxii. "For example, our examination found, according to one measure, that the percentage of borrowers who defaulted on their mortgages within just a matter of months after taking a loan nearly doubled from the summer of 2006 to late 2007. This data indicates they likely took out mortgages that they never had the capacity or intention to pay. You will read about mortgage brokers who were paid 'yield spread premiums' by lenders to put borrowers into higher-cost loans so they would get bigger fees, often never disclosed to borrowers. The report catalogues the rising incidence of mortgage fraud, which flourished in an

numbers of claims with such errors. MGIC, the largest MI company with a market share of 20–25 percent, reports that it paid 72 percent of claims presented.[54] This claims payment percentage seems roughly in line with the rate of mortgage fraud that was said to have occurred during the bubble period.

5. Require a one-page mortgage-information disclosure form. This form would present clear, straightforward key information that allows borrowers to answer the question, "Can I afford this loan now and in the future?" See appendix 3 for an example of what this form should contain.

6. Counter government policies that promote bubbles. For many years, especially through the affordable-housing requirements imposed on Fannie and Freddie, government policies have focused on expanding homeownership by reducing the cost of credit while at the same time promoting looser credit standards. This resulted in increased demand, higher debt levels, leverage, and inflation in adjusted and real home prices. These policy choices reinforced the tendency of the market to rely increasingly on nonprime loans as a boom progresses and the bubble grows. Regulation is necessary, then, to counter the propensity of the government to enact only expansionary policies and limit the incentives government creates for the private sector to originate nonprime mortgages.

The loan standards and accumulation of capital described above are countercyclical. They will promote steady growth and work against credit-induced housing booms and bubble formation. The following counterexpansionary and countercyclical policies, which automatically apply the brakes as risk levels rise, would provide additional protection.

- **Countercyclical leverage requirements for high LTV or Combined Loan-to-Value (CLTV) loans.** Homeowner and investor leverage tend to grow as housing prices rise; lenders respond to homebuyer demands for loans that will allow them to buy a more expensive house while keeping low monthly payments. Not only are down payments reduced, but LTVs are also increased by combining first and second mortgages to create high combined LTVs. A well-designed countercyclical policy would require, for example, that LTVs and CLTVs be automatically reduced (that is, down payments would be increased) when housing prices have risen by a given percentage in a local area. This would slow housing-price growth by directly reducing the leverage that homeowners can use to increase the price they will pay for homes. As housing prices return to normal levels, LTVs and CLTVs would do the same. In addition, second mortgages or other junior lien mortgages should only be permitted where the first mortgage holder has given its consent.

---

environment of collapsing lending standards and lax regulation. The number of suspicious activity reports—reports of possible financial crimes filed by depository banks and their affiliates—related to mortgage fraud grew 20-fold between 1996 and 2005 and then more than doubled again between 2005 and 2009. One study places the losses resulting from fraud on mortgage loans made between 2005 and 2007 at $112 billion."

[54] 2008–2010: $5 billion of claims paid
$2 billion of loss mitigation as a result of rescissions
71.5 percent of claims paid

At year-end 2010, MGIC had $5.9 billion in reserves. Derived from MGIC Investment Corporation, "10-K," March 1, 2011, 158 and 44, http://phx.corporate-ir.net/phoenix.zhtml?c=117240&p=irol-sec (accessed March 22, 2011).

- **Countercyclical loan-loss banking reserves.** Under current accounting standards, loan-loss reserves for banks and others are set based on recent delinquency and loss rates. However, bad loans are made in good times, when they seem good. The lean years inevitably follow the fat years, but under current reserve practices reserves are at their lowest levels at the beginning of a bust. Reserves should be built during good times, not bad.

- **Better appraisal practices.** Appraisers should report an estimated value using both the principle of substitution based upon comparable sales[55] and the principle of income capitalization based upon investment value as a rental.[56] Additionally, appraisals have long suffered from a lack of transparency in the selection of comparables.[57] This process would be remedied by identifying all appropriate comparables and using statistical techniques to help the appraiser select and reconcile all appropriate comparables. Transparency would allow the reader to validate and re-create the appraiser's comparable selection process. These provisions would be applicable to all federally related mortgages[58] and mortgages serving as collateral for private MBS and covered bonds.

7. Align economic interests and provide market transparency so investors, rating agencies, and guarantors are able to determine the number and quality of mortgages outstanding both at the point of origination and over time. Mortgage markets work best when aggregate risk levels are low and stable and when the economic interests of the various parties are aligned. It is now well understood that second mortgages do not met this test; on the contrary, the interests of the parties are actually in conflict. The interests of credit enhancers such as MI companies are generally aligned with investors' interests. Since MI generally attaches at loan origination, MI companies can take on the role of "cop on the beat"[59] because they could perform underwriting reviews prior to loan closing and conduct random sample reviews on a postclosing basis. Once these reviews are completed to the MI company's satisfaction, it might indicate that after a period of timely payments (say, twenty-four to thirty-six months), a loan will be presumed to be properly underwritten unless there are material shortcomings such as fraud, misrepresentation, or a significant property value discrepancy. To avoid adverse selection, this must rightly remain the responsibility of the originator. To reduce conflicts, the MI policy should provide for binding arbitration if a claim is denied.

Additionally, market participants must understand the true conditions in the market so they can properly assess the risk of investment. Nonprime loans increased rapidly over the period 1991–2007. This is best demonstrated by the rapid growth of home-purchase loans with little or no down payment. In 1990, one in two hundred home-purchase loans had a down payment of 3 percent or less; by 1999, it was one in ten; 2003, one in seven; and 2007, one in two and a half.

---

[55] The cost of acquiring a comparable property fixes the upper limit of valuation. This is accomplished by identifying and evaluating suitable comparable properties that recently sold.
[56] The capitalization of expected income (rents) fixes an upper limit of valuation.
[57] Edward Pinto, unpublished study, 1991.
[58] Generally, loans originated by institutions regulated by banking regulators or purchased or guaranteed by a federal agency or sponsored enterprise.
[59] This role was historically played by MIs however the advent of Fannie and Freddie's automated underwriting systems in the late-1990s largely displaced the MIs from being involved in the loan approval process.

The extraordinary level of nonprime lending created a fragile market that adversely affected homeowners, mortgage insurers, and mortgage investors. It is not clear that anyone in the market or in government in 2007 and 2008 understood the dimensions of the nonprime mortgage problem. Fannie and Freddie did not disclose the number of subprime and other nonprime mortgages they were buying, holding, and securitizing, and thus even close students of the mortgage markets did not know what they did not know. Accordingly, the first line of defense is to make sure that the mortgage finance market has the information necessary to understand the amount of nonprime lending that is occurring.

It is important to reduce the tendency of homebuyers, lenders, and investors to believe that just because housing prices are rising, it is sensible or prudent to originate or buy a mortgage loan that will be repaid only if housing prices *keep* rising. This could be achieved in part by better disclosure of the characteristics and delinquency rates of mortgages originated, sold, and held by investors, and postlending due diligence by the lending and securitization industry to confirm that originated loans are as described—particularly with respect to owner occupancy and the presence of second mortgages. The results of this due diligence would be disclosed.

Response to the Administration's and Others' Concerns

In its report, while seeing advantages in a private housing finance system, the administration also identifies drawbacks. We will address those below and show that none of them is an obstacle to the implementation of a stable mortgage market.

An increase in mortgage rates. Although the administration recognizes that any changes in the current system—including the reforms the administration itself is recommending—are likely to moderately increase mortgage loan rates and that this in itself has policy advantages, it did not specify the amount by which mortgage rates might increase. As noted above, it is likely that the private housing finance system we propose will be able to deliver mortgages at costs that are a modest ten to twenty-five basis points higher than a GSE loan after taking into account the higher GSE capital requirement that the administration has recommended. We also believe that even this spread will narrow as more liquidity comes into a growing and competitive securitization market in the future.

The thirty-year fixed-rate mortgage. We have already noted that thirty-year fixed-rate mortgages are readily available in the jumbo market, without any government backing, and pointed out that as a matter of public policy there is no reason for the taxpayers to subsidize these loans.

Access to capital in a crisis. The administration's report expresses concern about whether—in a fully private market—there will be sufficient access to mortgage credit during a crisis. The administration argues, "absent sufficient government support to mitigate a credit crisis, there would be greater risk of a more severe downturn, and thus the risk of greater cost to the taxpayer."[60] This idea gave rise to the administration's Option 2, which is a private market with a government backstop that would be invoked only in the event of a financial crisis that makes credit unavailable for housing. Government involvement in this case is said to be necessary because in the event of a crisis its guarantee will reassure investors and keep money flowing to housing. Earlier, we discussed the moral-hazard element of this and its tendency to cause overbuilding and harmful bubbles, while never adequately compensating the taxpayers for the risks they are underwriting.

If one assumes that some backstop is necessary, however, we point out that the Federal Reserve and the Treasury Department will still be there and have demonstrated their capacity for crisis intervention. Any intervention would be made easier by the fact that the outstanding mortgages would be largely of prime quality and could be backed by MI. As noted above, MI has the capacity to accumulate the reserves that would supply capital to back the mortgages in a fully private-sector market that has suffered a catastrophic decline. We do not believe it would be good policy to set up a government backstop for crisis conditions, since the tendency will be to use it even when there is no legitimate crisis. Instead, in a market where there are MI-backed prime mortgages insured down to 60 percent LTV, the Fed should be able to step in without significant credit risk to provide liquidity assistance in crisis conditions.

Shifting mortgage risk to too-big-to-fail (TBTF) institutions. In congressional testimony after release of the administration's report, Secretary Geithner observed that simply

[60] Departments of Treasury and HUD, *Reforming America's Housing Finance Market*, 28.

eliminating Fannie and Freddie and substituting a private financing system might amount to shifting mortgage risk from the GSEs to the major banks. If these banks are, as many believe, too big to fail (TBTF), then, he suggests, we have done nothing to relieve the taxpayers of potential liability. This is an important point, but there are a number of responses.

1. Banks have substantially larger capital requirements than did Fannie and Freddie and are far more diversified. They are able to bear greater losses without becoming insolvent. Moreover, to the extent that banks are holding mortgages or MBS, those loans are likely to be prime mortgages or MBS based on prime mortgages, not the subprime mortgages that caused the GSEs' insolvency.

2. Our proposal envisions a larger role in the mortgage system for securitization—involving only prime mortgages—than for banks. The major banks will of course be originators of a large percentage of the mortgages that will be made in the future, but most of these will be securitized and sold to institutional investors. In a securitization, the losses, if any, are taken by the subordinate tranches, not by the entity that structures the securitization or originated the loans. Thus, even assuming that the major banks are also the principal securitizers of the mortgages they originate, they will not be bearing the credit or interest-rate risk for these loans.[61]

3. To the extent that banks hold the loans they originate, or MBS backed by these loans, the credit risks they bear will likely be small, since the loans themselves will likely be prime quality and the MBS will be backed by prime loans with some form of credit enhancement.

4. Finally, we expect that banks and other institutional investors will be able, if they choose, to originate and hold whole mortgages that will not be of prime quality. Under our plan, these mortgages cannot be securitized and will expose the banks holding these loans to more credit risk than exposure to prime loans. For this reason, we propose that banks be assessed a higher capital charge for holding nonprime mortgages.

All of these elements, we believe, substantially reduce the likelihood that TBTF banks might impose losses on the taxpayers.

Preserving the "to be announced" (TBA) market. The TBA market depends on hedging to protect forward sellers of mortgages against interest rate and basis risk. As noted earlier, the benefits of TBA can be obtained at relatively small cost through hedging by the originating banks. This cost can be reduced further if the quality of the mortgages to be originated and sold in the future is clearly understood in advance. The GSEs were able to sell their mortgages for future delivery (the essence of the TBA system) because they were generally providing mortgages of uniform quality with narrow coupon spreads. Investors understood, before committing to purchase, what they would be getting in the future sale. This system was strengthened by the industry application of "good delivery" rules that substantially eliminated cherry-picking. We believe that the approach we have outlined in this white paper—because it

[61] Originators would presumably remain responsible for representations and warranties relating to compliance with loan origination standards.

creates prime mortgages of generally uniform quality—will allow a TBA market for private MBS to develop without subsidies or government guarantees. As the GSEs are wound down over a five-year period, the GSE TBA market will continue to be available for use as a hedging vehicle. As the private MBS market becomes larger and more liquid, a non-GSE TBA market for these securities will develop.

Preserving access to mortgage credit for credit-worthy American families. The administration's report notes that a fully private system "has particularly acute costs in its potential impact on access to credit for many Americans. While FHA would continue to provide access to mortgage credit for low-and-moderate income Americans, the cost of credit for those who do not qualify for an FHA-insured loan—the majority of borrowers—would likely increase." We addressed above the issue of increased cost for mortgage credit. What about the issue of access? As we noted earlier, according to a Federal Reserve study, over 70 percent of all individuals with credit records in the United States (not just all homeowners with credit records) have FICO credit scores that are 660 or above—the foundation for a prime loan. Well over a majority (58 percent) have credit scores above 700.[62] In both 1989[63] and 2010,[64] 87 percent of borrowers taking out a mortgage loan had a FICO of 660 or greater. In other words, these numbers show that the vast majority of potential homebuyers already have the basic requirement for a prime mortgage—a FICO credit score of at least 660. Further, the private approach we suggest preserves down payments as low as 10 percent on conventional prime loans for home purchase.

In this white paper, we are proposing to substitute prime mortgages for government backing as the foundation of a stable and robust housing finance system, primarily because government programs that have attempted to assist home construction or homeownership in the past have eventually become huge losses for taxpayers. Homeownership has long been a goal of US government policy, but the recent financial crisis shows that the government goes too far when it tries to make mortgage credit available to large numbers of borrowers who do not have the resources to sustain homeownership. The result was massive losses for Fannie and Freddie, which taxpayers will eventually have to pay, and a financial crisis and recession that are the worst since the Great Depression. If we must choose between government efforts to increase homeownership that result in huge costs for taxpayers, or a self-sustaining private system that provides stable financing for the vast majority of American families who are capable of sustaining homeownership—without any cost to taxpayers—the better choice is obviously private financing.

Small lenders and community banks could have difficulty competing. This is an important and legitimate issue, but it is based on mistaken facts and assumes incorrectly that the world will remain fundamentally the same after a private financing system is adopted. The government's involvement in the housing finance market through Fannie and Freddie distorted

---

[62] Board of Governors of the Federal Reserve System, "Report to Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit," August 2007, www.federalreserve.gov/boarddocs/rptcongress/creditscore/creditscore.pdf (accessed March 18, 2011).
[63] Letter in author's file dated October 30, 1989, to Ed Pinto from Equifax enclosing odds charts for new real estate accounts developed by Fair, Isaac Company (FICO).
[64] FICO presentation as American Securitization Forum 2011, "Consumer Metrics and Evaluation," February 6, 2011.

the market's structure. Because the GSEs were able to bid more for mortgages than any competitors, they drove competitors from the secondary mortgage market and created a duopsony (a market with only two buyers). They were then able to discriminate among their suppliers, providing better returns to those, such as Countrywide,[65] who provided the mortgages that they wanted, and penalizing those—primarily the small banks and S&Ls—that were unable to compete in the volume they could supply. In reality, then, although the GSEs bought many of their best loans from the small banks, community banks were victims, rather than beneficiaries, of the GSEs.

The private market that will develop if our proposal is enacted will be entirely different. Most mortgages will be prime loans—the kinds of loans that the small and community banks usually originate. These loans will be highly sought after because they will not only be good investments, but also the only type of mortgages that could be securitized. Since most mortgages will have the same prime characteristics, the key function in this new market will be aggregating the mortgages into pools for securitization. This is a role that can be performed by the small and community banks, capturing the profits that they previously had to give up to Fannie and Freddie. All that is necessary is regulatory approval to set up one or more joint ventures that will aggregate the mortgages produced by the members and prepare them for sale through underwriters, or to institutional buyers who want to hold whole mortgages. The more competitors in this field, the more innovation there will be and the lower they will push mortgage rates. This will be possible because the approach we have described relies on prime loans, a core competency of community banks and risk-based pricing.

[65] "Mortgage Bankers Association chief economist Jay Brinkmann said the pricing strategies that Fannie and Freddie pursued contributed to the concentration of mortgage lending within the largest banks. The GSEs offered reduced 'guarantee fees' for their largest customers, which placed smaller lenders at a competitive 'disadvantage,' he told the NABE annual conference." See "NY Fed Thinks Megabanks May Be the New GSEs," *National Mortgage News*, March 16, 2011.

III. All programs for assisting low-income families to become homeowners should be on budget and should limit risks to both homeowners and taxpayers.

There are good policy reasons for government to assist low-income families to become homeowners, but the value of this policy has to be weighed against the failure rate imposed on those ostensibly being helped and the cost to the taxpayers. Referring to the affordable-housing requirements imposed on Fannie and Freddie, even former House Financial Services Committee chair Barney Frank (D-MA) has noted that "it was a great mistake to push lower-income people into housing they couldn't afford and couldn't really handle once they had it."[66] Moreover, any program of this kind must be on budget and contain mortgage-quality standards that do not create market conditions similar to those that brought on the financial crisis. Finally, after all the years of trying and failing to increase homeownership without adding risk to the markets, perhaps it is time for Congress to rethink whether homeownership really should be given so many advantages over renting. With a more even-handed policy, rental properties would offer improved housing for people who are unable to—or should not be required to—take on the obligations of homeownership.

One of the ways to do this is to rein in FHA by limiting the scope of its lending, making sure its losses are sustainable over the long term, and putting it on budget through a mechanism more effective in identifying risks and losses than the Federal Credit Reform Act. Most of the administration's discussion of FHA in its report suggests that the administration shares these objectives, although at some points there is vague and troubling language suggesting that it has not yet learned the lesson of the Fannie and Freddie's financial collapse. "We will consider measures to make sure that secondary market participants are providing capital to all communities in ways that reflect activity in primary markets, consistent with their obligations of safety and soundness."[67] This is almost word for word what HUD was saying as it was deliberately undermining the safety and soundness of Fannie and Freddie and other market participants. At this point, everyone should understand that HUD's affordable-housing policies were directly responsible for the losses of Fannie and Freddie that the taxpayers will have to bear.

What is particularly pernicious about both the affordable-housing requirements and the rules concerning lending by insured depository institutions under the Community Reinvestment Act (CRA) is that they attempt to carry out government social policies by imposing requirements on private-sector entities. There are no controls on such a system. The private-sector entities are required to make loans they might not otherwise make, and the losses are passed along to the unwitting consumers of their services. The government has no incentive to reduce its pressures—as we saw, these pressures eventually drove Fannie and Freddie into insolvency—and the private-sector entities have no way to avoid the costs. The administration's report does not explicitly say that it will abandon these policies, but it does not say the opposite either. The political pressures to retain the CRA will be enormous, but the administration's arguments in

---

[66] Larry Kudlow, "Barney Frank Comes Home to the Facts," GOPUSA, August 23, 2010, www.gopusa.com/commentary/2010/08/kudlow-barney-frank-comes-home-to-the-facts.php#ixzz0zdCrWpCY (accessed September 20, 2010).

[67] Departments of Treasury and HUD, *Reforming America's Housing Finance Market*, 21.

favor of a private housing finance market and government agencies as the sources of support for low-income borrowers would seem to be inconsistent with making private-sector corporations the instruments for government social policies.

Much of the support for a government role in mortgage finance comes from groups that see housing finance as an opportunity to advance a social policy that expands homeownership. This is a worthwhile goal, but it must be carefully controlled if we are to avoid the problems that eventually forced Fannie and Freddie into insolvency. During much of their history, Fannie and Freddie safely and successfully facilitated the development of a liquid secondary market in middle-class mortgages. In 1992, however, they were given an affordable-housing mission, which eventually required them to take on the credit risk of almost $2 trillion in subprime and other weak mortgages.

What set US losses apart from those in other countries was the fact that—before the financial crisis began—about half of all mortgages in the United States, 27 million loans, were weak and liable to default when the housing bubble deflated. Of the 27 million high-risk mortgages, 19 million were on the books of Fannie and Freddie, FHA, insured banks and S&Ls under the CRA, and other lenders under additional government programs. All of these programs were intended to increase homeownership by low-income families, but they were instituted and operated without any controls over the risks that were being taken under government mandates. Eventually, their high rates of default drove down housing prices nationally and crippled the financial system.

Government assistance to low-income families must not be undertaken without quality standards that limit the risks to homeowners, the government, and taxpayers. By prescribing an outcome without limiting the means, the government encouraged loans and underwriting standards that were "flexible and innovative." This inevitably led to greater lending with minimal down payments along with lending to borrowers with impaired credit and higher debt ratios.

These policies assumed that borrowers who benefited from these flexibilities would be nearly as safe as borrowers with good or unimpaired credit. However, the risks that resulted from these underwriting concessions were well documented. A 1996 Fed study titled "Credit Risk, Credit Scoring, and the Performance of Home Mortgages"[68] pulls together unequivocal evidence from multiple sources on the high risks posed by "innovative or flexible" loan features such as low down payments and impaired credit/low FICO scores. This clearly shows the link between the government's insistence on loosened and flexible lending and the certainty of heightened mortgage default risk. See appendix 5.

Thus, if Congress wants to encourage homeownership for low-income families, then the mortgages intended to implement this social policy must be subject to a defined set of quality standards—not standards as high as those for prime mortgages, but standards that will ensure that losses do not get out of hand or, as they did with Fannie and Freddie and the FHA, cause substantial burdens for taxpayers. The nation's experience with the FHA demonstrates not only

[68] Federal Reserve, Division of Research and Statistics, "Credit Risk, Credit Scoring, and the Performance of Home Mortgages," *Federal Reserve Bulletin*, July 1996, www.federalreserve.gov/pubs/bulletin/1996/796lead.pdf (accessed January 14, 2011).

that standards are essential, but also that Congress has to avoid the political and other pressures that tend to erode the standards over time. See appendix 6.

Any social policy intended to increase homeownership, including the FHA, should be operated to achieve Congress's social policy goals while limiting homeowners' and taxpayers' risks. This can be achieved through the following steps.

1. On budget. Necessary subsidies must be on budget, so they are visible to members of Congress and voters. In the past, through Fannie and Freddie and the CRA, the subsidies have been hidden in the financial statements of GSEs and private-sector entities, which were required to make subsidized loans and pay for them with more expensive loans to prime borrowers. This, of course, is unfair to prime borrowers, who are being forced to pay for a social policy the cost of which should be borne by all taxpayers. But perhaps even more important, hiding the cost of the subsidies in private and GSE balance sheets obscures the cost to society. There are very good policy reasons for supporting low-income housing subsidies, but those costs should be made clear.

2. A sustainable loss rate. Although the FHA contends that it covers its losses adequately with fees, there are many who disagree with this view. A recent Barclays study concluded: "[W]e project cumulative default rates in the 20% area on average, with loss given default rates of 60%. This represents average losses of about 12pts, of which 8.5pts could flow back to taxpayers. On an original balance of $1.4trn, this translates to $130bn."[69] The administration seems to agree here, too, noting in its report that it will take steps to strengthen FHA's capital position and that it had already announced an insurance-premium increase.

3. Assist low-income borrowers without competing with private-sector lending. Lending to low-income borrowers increases the opportunity for families that cannot meet prime lending standards to gain the benefits of homeownership. Since it is done for social policy reasons—increasing homeownership among low-income families—taxpayers should take some risk. This risk, however, must be subject to some limits. The following low-income mortgage lending standards would provide credit for families that cannot meet prime loan standards but would still enable low-income families to become homeowners without exposing them or taxpayers to excessive foreclosure risk.

4. Limit to low-income borrowers. The FHA's benefits should be limited to low-income borrowers who are demonstrably unable to meet prime lending standards. This is important to ensure that the FHA is fulfilling its social policy purposes and not becoming a backdoor way for people who could otherwise meet prime lending standards to obtain mortgages at government-backed rates. Accordingly, the mortgage limit should be capped at 100 percent of median house values measured on the local level, the income limit should be capped at 80 percent of the area median income, and loans should be limited to home purchases and fixed-rate and term refinances. Although the administration was not as specific, it seems to be seeking to achieve the same goals. This would be accomplished in part by a series of reductions in FHA's mortgage limits, by allowing the temporary increase in loan limits to expire as scheduled on October 1, 2011. It also called for targeting FHA to creditworthy borrowers that have incomes up to the median level for their area and for reducing its risk exposure. All these policies are consistent

[69] Barclays, "US Housing Finance: No Silver Bullet," 6.

with our view that a private housing finance system is compatible with assistance to low-income home buyers as long as the taxpayers' liability for FHA's losses is clear and limited.

5. A sustainable lending underwriting standard. As outlined in appendix 6, the FHA seems to believe that a 10 percent average claim rate is acceptable. It is disappointing that, year in and year out, 10 percent of homeowners with an FHA loan should fail in the average year. Congress should establish a sustainable loan-underwriting standard that achieves an expected cumulative risk of default not to exceed 4 percent during good times and 9–10 percent during bad times.[70] This would result in an average expected claim rate of about 5 percent. The standards needed to achieve this claims level include the accumulation of adequate borrower equity by way of a reasonable down payment from the borrower's own funds, scheduled amortization during the first five years of the loan, evidence of a willingness to pay, and debt-to-income ratios that do not leave borrowers burdened with excessive debt right from the start. This supports a major goal of single-family affordable housing programs—wealth building through increased equity in a home.

6. Transition. Because the FHA currently has such a large portion of the home-lending market, transitioning to a sustainable lending standard will take a few years. Table 3 presents a possible path to achieve this result.

Table 3: FHA Transition to Sustainable Lending Standards
(FHA has already proposed or suggested changes with respect to the highlighted headings)

	LTV	Maximum seller concession	Maximum total debt ratio	Purpose	Mortgage limit (high/normal)	Income	Credit
2010	96.5% (current level)	6%	>45% for 37% of borrowers	Home purchase and refinance	$729,750/ $271,050	No limit	Current
2011	96%	3%	45%	Home purchase and rate and term refinance	$250,000 or area median home price if above $250,000	100% of area median	620–660 FICO[71]
2012	95.5%	3%	43%	Home purchase and rate and term refinance	$200,000 or area median home price if above $200,000	80% of area median[72]	620–660 FICO
2013	95%	3%	41%	Home purchase and rate	$150,000 or area median home price if	80% of area median	620–660 FICO

[70] During the boom years of 1995–2003, the FHA's cumulative claim rate averaged nearly 8 percent. During the bust periods (1980–1985 and 2005–2008), it averaged 18 percent. See the FHA's 2010 Actuarial Study.
[71] As noted previously, the FHA's serious delinquency rate on loans with a FICO score of 580–619 is 19.6 percent.
[72] The goal is to reduce the FHA's dollar limit back to a level commensurate with its low- and moderate-income housing mission. The FHA should serve homebuyers with an income less than or equal to 80 percent of the median. While regional adjustments would be appropriate, nationally, for a family of four, this equates to an income of $54,000 and below. A household with an income of $54,000 getting a 6 percent fixed-rate thirty-year mortgage could afford the median-priced house in the United States—about $175,000.

				and term refinance	above $150,000		
2014	95% for a twenty-five-year term* 90% for a thirty-year term*	3%	41%	Home purchase and rate and term refinance	100% of median home price by area	80% of area median	620–660 FICO

* By setting a twenty-five-year loan term on 95 percent LTV loans and a thirty-year loan term on 90 percent LTV loans (both at an interest rate of 5 percent), each borrower would have about 16–17 percent equity (based on original sales price) after five years. This compares to about 11 percent equity (based on original sales price) for an FHA borrower with a 96.5 percent LTV loan with a thirty-year loan term. This last borrower barely has enough equity to cover the selling expenses in the event of a sale.

7. Down payments and savings. The FHA provides its benefits through the traditional means used in the United States—by subsidizing the cost of a mortgage loan. However, that is not the only way—and possibly not the most effective way—to achieve its purposes. Studies by the US Census Bureau have shown that the greatest obstacle to homeownership among low-income families is not the monthly cost of the mortgage but the savings necessary for a down payment.[73] Accordingly, one of the ways for Congress to assist homeownership among low-income families within the lending standards we suggest would be to establish a program for providing down payment assistance to these families. Such a program should be designed to promote real savings by the potential homebuyer. For example, Congress could set up a tax-preferred savings plan to which the government contributes an amount each year that matches a family's savings. The funds would accumulate in an FDIC insured account and could be used only as a down payment for a home.

[73] Howard A. Savage, *Who Could Afford to Buy a House in 1995?* (Washington, DC: US Department of Commerce and US Census Bureau, August 1999).

IV. Fannie Mae and Freddie Mac should be eliminated as GSEs over time.

Fannie Mae and Freddie Mac violate every principle of sound and sustainable housing finance. The history of these two hybrid firms, and the immense costs they have imposed on taxpayers, provides the best argument for the principles we have outlined in this paper. Through Fannie and Freddie, government policies exponentially increased taxpayer risks, now realized as actual losses, by using the two firms to compete with the FHA in pursuing a political strategy of high-risk loans. Fannie was "privatized"—really, GSE-ized—in 1968 for the explicit purpose of keeping its costs out of the federal government's budget. Congress then copied the model with Freddie. But the costs have returned to the budget with a vengeance. Fannie and Freddie distorted resource allocation, prices, and credit, and were leading contributors to inflating the disastrous housing bubble that collapsed in 2007. As a result, almost everyone now agrees, including almost everyone in Congress, that Fannie and Freddie's GSE status should be eliminated.

This leaves two questions: What should replace the GSEs? How should the transition be structured? We conclude that the GSEs should be—and can be—replaced by a housing finance market that is for the most part free of government guarantees and the distortions they create.

In its report, the administration recognized that no private-sector market for financing mortgages will be able to develop fully until competition from Fannie and Freddie is first reduced and then eliminated. To this end, the administration's report calls for a transition away from the dominance of Fannie and Freddie, thus allowing private financing mechanisms to grow. Accordingly, while we and the administration target the elimination of Fannie and Freddie as GSEs, we both propose a gradual wind down.

A key transition feature that now appears to be generally accepted calls for a gradual reduction in the conforming loan limit that sets the maximum size of the mortgages that Fannie and Freddie can purchase. As this limit is reduced, Fannie and Freddie will be taken out of the market for loans above the limit. This will enable the private market to expand its activity gradually. The administration proposes to start this process by recommending that the temporary increase in loan limits be allowed to expire as scheduled on October 1, 2011.

The elements of the transition away from GSE status should include:

- **Reduce conforming loan limits.** While the administration appears to agree that the loan limits must be reduced, its report makes no recommendation beyond the small initial step noted above. We believe it is critical for the private market to be provided a definite schedule of reductions for the next three years. This will allow the necessary investments to be planned and made. We recommend lowering the conforming loan limit by 20 percent of the previous year's cap each year, starting with the current general limit for one-unit properties of $417,000 and the high-cost area limit of $729,750. These limits, for loans, mean house prices of over $500,000 and over $1,000, 000, respectively, are financed by the government. In contrast, according to the National Association of Realtors, the median US house price is $171,300. The general limit for a one-unit property would decrease to $334,000 in year one, $267,000 in year two, $214,000 in year three, $171,000 in year four, and $139,000 in year five. The high-cost area limit for a one-unit property would decrease to $584,000 in year one, $467,000 in year two,

$374,000 in year three, $296,000 in year four, and $237,000 in year five. Final termination or "sunset" of GSE status would take place at the end of year five.

- **Wind down investment portfolios and limit nonmortgage investments.** While Treasury and HUD note that Fannie and Freddie were allowed to behave like government-backed hedge funds and therefore conclude that Fannie and Freddie's investment portfolios should be wound down, the schedule is painfully slow. Under the current structure, which predates the administration's decision to wind down Fannie and Freddie, this could take as long as twelve years and still leaves them with investments of up to $500 billion in 2022.

Table 4: Limited Wind Down of GSEs' Portfolios under Current Policy

As of Dec. 31:	Fannie limit	Fannie actual	Freddie limit	Freddie actual
2009	$900 billion	$773 billion	$900 billion	$755 billion
2010	$810 billion	$789 billion	$810 billion	$697 billion
2011	$729 billion	*	$729 billion	*
2012	$656 billion	*	$656 billion	*
2013	$590 billion	*	$590 billion	*
2014	$531 billion	*	$531 billion	*
2015	$478 billion	*	$478 billion	*
2016	$430 billion	*	$430 billion	*
2017	$387 billion	*	$387 billion	*
2018	$349 billion	*	$349 billion	*
2019	$314 billion	*	$314 billion	*
2020	$282 billion	*	$282 billion	*
2021	$254 billion	*	$254 billion	*
2022	$250 billion[74]	*	$250 billion*	*

Note: * = Unknown
Source: Derived from Fannie and Freddie 2010 10-Ks, December 2010 Monthly Reports, and "Second Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement," dated December 24, 2009, www.svb.com/pdfs/sam/fannie509amendment.pdf (accessed March 22, 2011).

A better approach and one consistent with the wind-down goal would prohibit Fannie and Freddie from adding existing or newly acquired single-family or multifamily loans or MBS to their portfolios, with exceptions only for newly acquired loans held for a short period before securitization and the purchase of delinquent or modified loans out of an existing MBS. With no additions allowed, natural runoff should substantially reduce their portfolios over time. Establishing a specific requirement for sales in any year could allow the government to be gamed or arbitraged. While hard to predict, these changes should reduce taxpayer portfolio exposure to a combined $500 billion (a reduction of two-thirds) by 2016 compared to the current trajectory, and do so without putting pressure on housing or MBS prices. To the extent a GSE has portfolio assets remaining at the fifth-year sunset, these should be put in a liquidating trust and defeased or sold to other

[74] Once the portfolio limit is reduced to $250 billion, no further decreases are required.

investors. During the wind-down period, Fannie and Freddie should be allowed to buy only prime loans as defined in appendix 1.

The administration recommended a move in this direction by calling for an increase in the GSEs minimum down payment requirement from 3 percent to 10 percent. We suggest doing this in phases: the FHFA director would direct the GSEs to set a maximum single-family CLTV limit of 95 percent in 2011. This CLTV ratio would decrease to a maximum of 92.5 percent on January 1, 2014, and would be applicable until the sunset of the GSE charters at the end of 2015.

Going forward, the GSEs' new nonmortgage investments should consist only of Treasury securities.

- **Raise the GSEs' capital requirements to equal those of national banks and rely more on private capital.** The administration also recommends this step. It would eliminate the unfair capital advantages that Fannie and Freddie did and do enjoy and reduce the gap between Fannie and Freddie's subsidized pricing and private-market rates. An increase in capital requirements would require the GSEs to raise their base guarantee fee by perhaps fifteen to twenty-five basis points (this fee currently averages twenty-five basis points), a step already taken by the administration and one that would result in a gradual reduction in the GSEs' pricing advantage over the private sector. As suggested by the administration, the FHFA director should explore various means of credit enhancement to reduce the liability of the GSEs for losses on mortgages, including the possibility of increased mortgage guaranty insurance.

- **Dividend on preferred stock held by Treasury.** The dividend should be set by statute to yield not less than 10 percent annually. Secretary Geithner expressed this policy at a March 1, 2011, hearing before the House Financial Services Committee.

- **Recoupment of costs of federal guarantee.** Beginning on January 1, 2014, the GSEs should be required to make quarterly payments to the Treasury equal to an annualized thirty basis points times the average aggregate outstanding credit risk of the GSE. This provision will enable the taxpayers to recoup the value of the government guarantee of the GSEs' mortgage portfolios and MBS.[75]

- **Repeal affordable-housing goals and taxes.** Consistent with Principles I and III above, repeal the GSE (including the FHLB) affordable-housing goals and affordable-housing support fees.[76]

---

[75] This level of guarantee fee is consistent with the CBO's budget estimates, which price the value of the government's backing of the GSEs at 4.4 percent in 2009, reducing to .20 percent (twenty basis points) in 2014 and thereafter. Thirty basis points seems a good middle point, consistent with the CBO study. See Congressional Budget Office, *CBO's Budgetary Treatment of Fannie Mae and Freddie Mac* (Washington, DC: January 2010), table 2, www.cbo.gov/ftpdocs/108xx/doc10878/01-13-FannieFreddie.pdf (accessed March 22, 2011).

[76] Supra. Housing and Economic Recovery Act of 2008 (HERA). HERA imposed a 4.2-basis-point fee on Fannie and Freddie's mortgage purchases (currently suspended by FHFA).

- **Privatization.** At the sunset date, the conservatorship will be converted to a receivership, the equity below the Treasury's holdings will be wiped out, and the GSEs will be divided into good bank/bad bank structures. If there are buyers for the GSEs as going concerns (no longer in GSE form), or capital is available for their restructuring as fully private nongovernment entities, the good banks will be sold and the bad banks will be liquidated by creating a liquidating trust that contains all remaining mortgage assets, guaranty liabilities, and debt. The obligations of the trust will be defeased with the deposit of Treasury securities. As obligations arise that exceed the revenues of the trust (from mortgage payoffs or refinancing), the Treasury securities will be liquidated to meet the obligations. The GSE net worth shortfall will unjustly—but at this point unavoidably—be borne by taxpayers, including Treasury's writing off its preferred stock.

- **Dispositions of properties other than through privatization.** If there are no buyers for the GSEs in the good bank/bad bank structure, all their intellectual property, systems, securitization platforms, goodwill, customer relationships, and organizational capital should be auctioned off. The proceeds would reduce the Treasury's and taxpayers' losses.

The reasons for winding down Fannie and Freddie imply other policy choices that should be considered as part of a thorough reform of the US housing finance system:

1. Coincident with the wind down of Fannie and Freddie, Congress should establish a legal structure that allows for a number of private financing options. Although we believe a combination of a market based on portfolio lending and securitization of loans would be the most effective immediate replacement for a government-backed housing finance market, there are many other alternatives. Covered bonds would make a sensible additional fixed-rate funding alternative for mortgages. With covered bonds, banks issue debt for which they remain liable (thus, having 100 percent "skin in the game"), secured by loans.

This could include incorporating some of the benefits of the Danish system, which divides the credit and interest-rate risks on mortgages, and the German system, which has strict mortgage credit standards. In the Danish system, the interest rate on mortgages is set by the market directly, and the credit risk is taken by specialized mortgage banks that also function much like mortgage guarantors. Throughout the more than two-hundred-year history of German covered bonds, there has never been a default of a German Pfandbrief or covered bond[77] or a default by a Danish mortgage bank. For such a system to work, there must be statutory (not just regulatory) protection of the right of the bondholders to the collateral in the event of the failure of the issuer, as well as a requirement that the mortgages covering the bonds be of prime quality. Thus, any framework that establishes requirements for mortgage quality should be compatible with a variety of mortgage financing structures, all of which should be able to operate simultaneously in the US market.

The political obstacle in the United States has been the objections of the FDIC, which fears that in the event of a failure, it will lose assets that would otherwise be part of a bank and

[77] Association of German Pfandbrief Banks, "The Pfandbrief—A Safe Investment," www.hypverband.de/cms/bcenter.nsf/docsbykey/65192645/$file/Flyer+EN_Pfandbrief_a+safe+investment.pdf?openelement (accessed January 14, 2011).

thus increase its losses to its deposit-insurance scheme, like what happens with FHLB advances. This concern can be addressed by limiting the extent of collateralization of the covered bonds (for example, the percentage of overcollateralization might be limited to the capital ratio of a bank, so the excess collateral is in effect funded by capital, not deposits).

2. FHLBs: Reduce risks these GSEs present to taxpayers and focus their support on small- and medium-sized financial institutions. The administration noted that the FHLBs "developed significant weaknesses as the housing market evolved that should be addressed as part of housing finance reform." Also noted was the need to address the FHLBs' advance funding (lending secured by loans) to very large banks. The suggested reforms address fundamental banking principles that expose the taxpayers either directly (as a result of the FHLBs' GSE status) or indirectly (as a result of the combination of the FHLBs' implicit guarantee with the FDIC's explicit guarantee). We agree and suggest the following:

- **Adopt a loan-to-one-borrower limit.** This universal financial concept applies to all other banks. The administration recommended limiting the level of advances to any given institution. Dodd-Frank limits maximum exposure to one borrower to 25 percent of capital, but FHLBs were excepted in the Senate negotiations. This should be reconsidered. Even limiting them to 50 percent of capital would be a major constraint on their use of the implied guarantee, since individual FHLBs lend multiples of their capital to certain borrowers. For example, FHLBs lent $50 billion to Countrywide, $90 billion to Citigroup, $40 billion to WaMu, and $10 billion to IndyMac.

- **Stop the double leveraging of the FHLBs through the banking system.** When banks buy stock in the FHLBs, they are allowed to create high leverage for this equity investment (sixty to one in risk-based terms—20 percent risk weighting). Instead, they should have to hold dollar-for-dollar equity of their own, or at least have a much higher capital requirement for FHLB stock investments. These equity investments are financed by deposits, and there is very little equity in the FHLB banking system viewed on a consolidated basis. The disaster of bank investments in Fannie- and Freddie-preferred stock demonstrated this problem, since numerous banks took large losses and some failed because of their highly leveraged investments in GSE equity.

- **Reducing portfolio investments.** Treasury/HUD noted that similar to Fannie and Freddie, several of the FHLBs had built up sizable investment portfolios. Using their GSE status, these banks were able to use their implicit guarantee to earn arbitrage profits. Treasury/HUD recommend that the size of these portfolios should be reduced and their compositions changed to better support legitimate liquidity needs and reduce credit exposure.

- **FHLBs take very large collateral haircuts to secure their advances.** In the event of bank failure, these haircuts cause losses to be passed on to the FDIC and—in the S&L bailout of 1989—to the taxpayers. For example, when the FHLB of San Francisco made advances to IndyMac secured by risky mortgage loans, it required 100 percent overcollateralization. To a large measure, this excess collateral was financed with FDIC-guaranteed deposits rather than bank capital and contributed to

the FDIC's estimated $10 billion loss. This is the same problem the FDIC points out in its opposition to covered bonds. A limit on the extent of overcollateralization by FHLBs is appropriate.

3. The four principles outlined in this white paper are equally applicable to multifamily housing finance. The federal government has long supported the multifamily housing finance market. This support includes government insurance (FHA), MBS guarantees (Fannie, Freddie, and Ginnie), on-budget subsidies (HUD and USDA), off-budget mandates (Fannie and Freddie), off-budget subsidies (FHLBs), and low-income tax credits (before Fannie and Freddie's collapse, they were the largest purchasers). Before the GSEs' involvement, life-insurance companies, pension funds, and banks supported a robust conventional multifamily lending market.

In the late 1970s, HUD pushed Fannie and Freddie to undertake multifamily lending as part of its early efforts to enforce a GSE affordable-housing mission. These programs proved to be high risk, with Freddie completely exiting the multifamily business in the late 1980s after sustaining substantial losses.[78] By imposing affordable-housing requirements for multifamily as well as single-family mortgages, the 1992 act forced Freddie back into multifamily finance and both GSEs were required to greatly expand their programs. As was the case with single-family financing, the private sector had an ever more difficult time competing with the GSEs' charter advantages. Today Fannie and Freddie,[79] along with FHA, have now largely taken over the multifamily finance market.

Many of the proposals for reform of the housing finance market argue for continued federal government financial support for multifamily housing,[80] either through an explicit or

---

[78] Fannie also lost substantial sums on a $5 billion portfolio of 6 percent multifamily loans it had acquired from HUD when long- and short-term interest rates topped 15 percent in the early 1980s.

[79] "In the current market, the GSEs hold 35 percent of total outstanding multifamily mortgage debt and are providing nearly 90 percent of all mortgage capital to the market." See Ingrid Gould Ellen, John Napier Tye, and Mark A. Willis, "Improving US Housing Finance through Reform of Fannie Mae and Freddie Mac: Assessing the Options," Furman Center for Real Estate & Urban Policy, Institute for Affordable Housing Policy, and What Works Collaborative, May 2010, http://furmancenter.org/files/publications/Furman_Center_GSE_Reform_White_Paper_May_2010.pdf (accessed March 21, 2011).

[80] Ibid. See also "MBA's Recommendations for the Future Government Role in the Core Secondary Mortgage Market," Mortgage Bankers Association, August 2009, www.mbaa.org/files/News/InternalResource/70212_RecommendationsfortheFutureGovernmentRoleintheCoreSecondaryMortgageMarket.pdf (accessed March 21, 2011); *Housing Finance—What Should the New System Be Able to Do? Testimony Before the House Financial Services Committee*, 111th Cong. (April 14, 2010) (statement of Jack E. Hopkins, Independent Community Bankers Association), http://financialservices.house.gov/Media/file/hearings/111/Printed%20Hearings/111-121.pdf (accessed March 21, 2011); *The Future of Housing Finance—A Review of Proposals to Address Market Structure and Transition, Testimony Before the House Financial Services Committee*, 111th Cong. (September 29, 2010) (Michael J. Heid, Housing Policy Council), http://financialservices.house.gov/Media/file/hearings/111/Heid092910.pdf (accessed March 21, 2011); *Housing Finance—What Should the New System Be Able to Do? Testimony Before the House Financial Services Committee*, 111th Cong. (April 14, 2010) (statement of Sheila Crowley, National Low Income Housing Coalition), www.nlihc.org/doc/Testimony-of-Sheila-Crowley4-14-2010.pdf (accessed March 21, 2011); and Mortgage Finance Working Group, *A Responsible Market for Housing Finance*, (Washington, DC: Center for American Progress, December 2009), www.americanprogress.org/issues/2009/12/pdf/housing_finance.pdf (accessed March 21, 2011).

implicit government guarantee of agency or private MBS or the need for a GSE or other similar entity with substantial ongoing portfolio capacity. A detailed treatment of multifamily housing finance is beyond the scope of this white paper. However, the lessons from the single-family disaster have direct applicability to multifamily housing finance and the risks posed to taxpayers. While the multifamily lending business is less than $1 trillion, or under 10 percent of the single-family finance market, it is even more complex and risky. Although the GSEs' recent multifamily lending efforts have resulted in low losses, there is a long history of costly multifamily failures at the GSEs and at FHA. It is also clear from the various industry proposals for future GSE participation in multifamily lending that there will be pressure to move the GSEs and FHA into riskier types of loans. Combine this with continued federalization of multifamily mortgage credit and the risks to taxpayers are substantial.

The four principles outlined in this white paper should be applied to multifamily housing finance. The inability to price risk, or create reserves for potential losses, and the moral hazard created by government financial support for the industry will have the same adverse effect in multifamily housing as it has had in the single-family market. Federal guarantees and mandates will distort the incentives and behavior of borrowers, lenders, and investors alike and prevent the multifamily market from developing normally with private-sector support. Good-quality mortgages backed by good-quality rent rolls can restore a private market in multifamily housing.

As is the case with single-family finance, a gradual removal of government support by the GSEs and FHA, and the resulting price advantage, will be necessary to give traditional financing sources time to re-enter the business. This will allow a private multifamily financing sector to develop based on solid underwriting and the use of financing mechanisms already available.

Appendix 1:

Definition of a Prime Loan

A prospective prime borrower needs to be qualified based on a demonstrated ability to repay the loan, a demonstrated willingness to meet his or her obligations, and sufficient equity to reduce the likelihood of default to a reasonable level.[81]

We define *prime first mortgage loans* as loans with the following characteristics:

- Conventional loans on properties occupied as a primary or secondary residence.[82]
- Home purchase loans with an LTV of 90 percent or less commencing on January 1, 2016.[83] During the five-year GSE wind down and private-market transition period we recommend, an LTV limit of 95 percent would be permitted until December 31, 2012, and an LTV limit of 92.5 percent would be permitted until December 31, 2015.
- Rate and term refinances with an LTV of 80 percent or less with a maximum loan term of twenty-five years.[84]
- Cash-out refinances with an LTV of 75 percent or less with a maximum loan term of twenty years.[85]
- As noted, research shows that loans with an LTV of 60 percent or less sustain virtually no losses. Therefore, any loan with an LTV greater than 60 percent could be insured by mortgage guaranty insurance down to 60 percent; however, a fully amortizing loan with a term of fifteen years or less and an LTV greater than 80 percent could be insured by mortgage guaranty insurance down to 70 percent.
- Loans to borrowers with a demonstrated willingness to meet their obligations as represented by a FICO credit score of 660.[86]
- No second mortgage at loan origination and prohibited by the mortgage documents for a period of six months after origination. The mortgage documents also grant the mortgage holder and mortgage insurer (if any) the right of prior approval with respect to any second mortgage taken out after six months.
- The mortgage note and mortgage shall:
    - Require the borrower to declare his or her intent regarding owner occupancy;

[81] These represent the traditional Three Cs of mortgage risk:

Credit or willingness to pay—generally represented by evaluation of a credit report.

Capacity or ability to pay—generally represented by evaluation of income and liability information measured against housing and other debt ratios.

Collateral underlying the mortgage—generally represented by evaluation of amount and source of down payment information and an appraisal to determine the value of a property for lending purposes.

[82] In 1991, over 98 percent of Fannie's loans met this standard. Data from Fannie Mae's random sample review covering single-family acquisitions for the period October 1988–January 1992, dated March 10, 1992. Document contained in the authors' files.

[83] Ibid. In 1991, over 91 percent of Fannie's home-purchase loans had LTVs of 90 percent or lower.

[84] Ibid. In 1991, over 93 percent of Fannie's loans had LTVs of 80% or lower.

[85] Ibid. In 1991, over 92 percent of Fannie's loans had LTVs of 75% or lower.

[86] Ibid. In 1991, over 98 percent of Fannie's loans had one or no mortgage late payments at origination and 85 percent had two or fewer nonmortgage late payments at origination.

    - Require the borrower to acknowledge that if the intent to occupy changes within twelve months of the date of the loan, the borrower has an affirmative obligation to notify the lender;
    - Advise the borrower that upon receipt of such notice, the lender has the right to increase the interest rate on the loan by a stipulated percentage; and
    - Provide that if the borrower fails to notify the lender, the lender may call the loan and require its immediate repayment, and such loan, if not already recourse to the borrower, becomes recourse and not dischargeable in bankruptcy.
- Housing and total debt-to-income ratios of less than 33 percent and 38 percent, respectively[87] (28 percent and 33 percent on 95 percent and 92.5 percent loans during the five-year transition period).
- Underwritten based upon verified income, assets, and credit.[88]
- If an adjustable-rate mortgage or balloon, an initial fixed rate for seven years or more, with the borrower qualified at the maximum rate permitted during the first seven years.
- If a prepayment fee is charged, it may not provide for a fee in excess of 3 percent of principal for the first year, 2 percent for the second, and 1 percent for the third, and the originating lender must offer the applicant the option of a similar loan with no prepayment fee.

The following are the standards that federal regulation should require of mortgage insurers for prime loans:

- Maintain minimum risk-to-capital ratios by amortized LTV based on the lesser of sales price (if applicable) or original appraised value, as set forth below:

Amortized LTV (%)	Suggested risk-to-capital ratio for thirty-year fixed-rate loans[89]	Current risk-to-capital ratio
92.51–95.00	8 to 1	25 to 1
90.01–92.50	10 to 1	25 to 1
85.01–90.00	13 to 1	25 to 1
80.01–85.00	16 to 1	25 to 1
75.01–80.00	29 to 1	25 to 1
70.01–75.00	31 to 1	25 to 1
65.01–70.00	38 to 1	25 to 1
60.01–65.00	41 to 1	25 to 1

[87] Ibid. In 1991, over 90 percent of Fannie's loans met this standard.
[88] Fannie stopped acquiring low-doc or no-doc loans in 1990. Freddie followed in 1991. See "Haste Makes . . . Quick Home Loans Have Quickly Become Another Banking Mess," *Wall Street Journal*, July 5, 1991.
[89] Fixed-rate loans with shorter amortization periods pose a lower risk of default due to faster buildup of borrower equity and therefore would have somewhat higher risk-to-capital requirements (requires that less capital be held). For example, fifteen-year term loans at an 80 percent LTV might have a thirty-eight-to-one risk-to-capital ratio, the same as for a 70 percent LTV loan with a thirty-year term.

- As noted, MI is required on all loans with an LTV above 60 percent up to the prime loan LTV limit of 90 percent (except as provided for the five-year period during which the GSEs are wound down. This coverage is required down to 60 percent.[90] For example, on a 90 percent LTV loan, MI would provide 34 percent coverage, which would insure down to 59.4 percent. Under the above risk-to-capital requirement, MI would be required to maintain a minimum equal to 7.7 percent (the inverse of the thirteen-to-one risk-to-capital ratio) times coverage of 34 percent or 2.62 percent against this prime-loan risk. This compares to 4 percent (the inverse of the twenty-five-to-one risk-to-capital requirement) times coverage of 25 percent or 1 percent against loans that in the last decade consisted of many nonprime loans.
- Fifty percent of gross premiums required to be placed in statutory premium reserve (same as current requirement) for a fixed period (current period is ten years) and may only be used to pay nonnormal or catastrophic stress-based losses due to periodic but unpredictable general economic risks as described earlier. The other 50 percent of premium revenue is required to support normal claims related to specific or actuarially based credit losses, general and administrative expenses, taxes, other expenses, dividends, and profits.
- Monoline (same as current). A monoline insurer's business is limited to one line of insurance, in this case mortgage guaranty insurance on prime single-family first mortgages.
- Coverage is loan based with a maximum coverage of 35 percent after 2015 and a maximum coverage of 38 percent during the five-year transition period (current practice). No pool coverage or guaranty of securities (new provision). MI companies are limited to covering individual loans rather than pools of loans.
- No originator, aggregator, conduit, or issuer (or affiliates or parents) may own or operate a private mortgage insurer (new provision). The Alger report noted a need to avoid conflicts of interest between originators and credit enhancers.[91]
- Restricted to prime loans (new provision). This limits MI companies to prime loans, which have more predictable and lower default rates than nonprime loans. No sharing of premiums with lenders or investors (a new provision designed to prohibit captive subsidiaries) and any discounts must be risk based, not volume based (current practice). A captive subsidiary is an MI reinsurer controlled by the loan originator. Countrywide was an early and large participant in the practice. Its prohibition helps eliminate conflicts of interest. In terms of pricing, Fannie and Freddie offered large volume-based discounts, whereby lenders such as Countrywide were charged a guaranty fee of about ten basis points, while community banks were charged twenty basis points or more.

[90] Coverage must be maintained until the original loan balance amortizes to 60 percent based on the lesser of original sales price (if applicable) or original appraised value.
[91] Report to the governor of New York by Commissioner George Alger (Alger Report) regarding the operation, conduct, and management of mortgage guaranty corporations dated October 5, 1934. Document contained in the authors' files.

Appendix 2:

Nonprime Loans

As noted under Principle II, nonprime loans are inappropriate for inclusion in private MBS or covered bonds. This means that nonprime loans will have to be held in the portfolio of a bank or other entity.

Additionally, nonprime loans contained in the portfolios of leveraged entities such as depository institutions should be subject to a variable capital requirement that adjusts as the share of nonprime loans in the origination market changes.[92] This would be accomplished by setting capital requirements that automatically adjust as nonprime loans' share of all originations changes. Implementing this requirement necessitates tracking the quality characteristics of all mortgage loans. This allows for a determination of the percentage of prime and nonprime loan originations entering the market on a quarterly basis.

Loans held in portfolio need to be backed by capital to address three risks: normal credit risk, interest-rate risk, and catastrophic risk.

- Prime fixed-rate loans would be subject to a 1 percent capital requirement for credit risk, 3 percent for interest-rate risk, and zero percent for catastrophic risk. Different capital requirements would be applicable to ARM loans.
- Nonprime fixed-rate loans would be subject to a 5 percent capital requirement for credit risk, 3 percent for interest-rate risk, and a range from zero percent to 6 percent for catastrophic risk. A different capital requirement would be applicable to ARM loans. The catastrophic risk capital component for fixed-rate loans would be determined based on the following:

Nonprime percentage of loan originations for a quarter (%)	Catastrophic risk capital requirement applicable to all nonprime loans held in a bank's portfolio (%)
0–20	0
20.01–25	1
25.01–30	2
30.01–40	4
40.01–50	6
>50	8

[92] FHA and other social policy loans would be included in this calculation.

This countercyclical policy yields two results: increased capital as a cushion against loan losses and/or reduced originations of higher-risk nonprime loans to fuel an unsustainable boom.

Appendix 3:

THE BASIC FACTS ABOUT YOUR MORTGAGE LOAN

Borrower:______________________ Property address: ______________________________
______________________ ______________________________
____

Lender:____

Amount of loan: $__________________, which is______ % of the property's appraised value.
Your loan is for ________ years.
The type of loan you have:____

Your beginning interest rate is _____%. This rate is good for _______ months/years. The rate and your payment can go higher by up to ____% on and each _____ months after that.

One estimate of what your future rate could be, called the fully indexed rate, is ____________ _____%.
The maximum possible rate on your loan is ________%. You were qualified for approval using a rate of _____%.

THIS LOAN IS BASED ON YOUR MONTHLY INCOME OF $__________.

Your beginning rate = a monthly loan payment of $________________ = __________% of your income.
-including taxes and insurance this is about $________________ = __________% of your income.

The fully-indexed rate = a loan payment of $________________ = __________% of your income.
-including taxes and insurance this is about $________________ = __________% of your income.*
*This is called your fully indexed housing expense ratio.

Special factors you must be aware of:
-A prepayment fee of____________________ must be paid if_________________________.
-A "balloon payment" of $__________________ to pay off your loan will be due on____________.
-You do/do not have a loan with possible "negative amortization". If you do, make sure you really understand what this means. Start with the definition on p. 3.

Total "points" plus estimated other costs and fees due at closing are $______________________________.

FOR QUESTIONS CONTACT: Name:____

Phone:____________________ e-mail:__________________________

See definitions of underlined terms and guidelines on pages 2–3.
DO NOT SIGN THIS IF YOU DON'T UNDERSTAND IT!

____
Borrower Date

______________________________ ______________________________________
Authorized Signer of Lender Date Borrower Date

The Basic Facts about Your Mortgage Loan

This form gives you the basic facts, but some mortgage forms may use terms not listed here. For a good, borrower-friendly information source, try the Mortgage Professor online (www.mtgprofessor.com), which includes detailed explanations of the technical mortgage terms in its glossary and much other helpful information.

Definitions and Guidelines Used in This Form

The *appraised value* is what a professional appraisal estimates the house could be sold for in today's market.

The *type of loan* determines whether and by how much your interest rate can increase. If it can, your monthly payments will also increase—sometimes by a lot. For example, in a thirty-year fixed rate loan, the interest rate is always the same. In a one-year ARM, it will change every year. Other kinds of loans have various patterns, but the interest rate may go up a lot. Make sure you understand what type of loan you're getting.

The *beginning interest rate* is the interest you are paying at the beginning of the loan. It is the rate which you will hear the most about from ads and salespeople. But how long is it good for and when will rates increase? In many types of loans, the rate can go up by a lot. You need to know.

The *fully-indexed rate* is one indicator of what can happen to your interest rate and your monthly payments. It is calculated by taking a defined "index rate" and adding a certain number of percentage points, called the "margin." For example, if the rate formula on your loan is the one-year Treasury rate plus 3 percent, and today the one-year Treasury rate is 5 percent, your fully-indexed rate is 5% + 3% = 8%. This will almost always be higher than your beginning rate.

The index rates are public, published rates, so you can study their history to see how much they change over time. If the index rate stays the same as today, the rate on your loan will automatically rise to the fully-indexed rate over time. Since the index rate itself can go up and down, you cannot be sure what the future adjustable rate will be. In any case, you must *make sure you can afford the fully-indexed rate*, not just the beginning rate, which is often called a "teaser rate" for good reason.

The *maximum possible rate* is the highest your interest rate can go. Most loans with adjustable rates have a defined maximum rate or "lifetime cap." You need to think about what it would take to make your interest rate go this high. How likely do you think that is?

Your *monthly income* means your gross, pre-tax income per month for your household. This should be an amount which you can most probably sustain over many years. Make sure the monthly income shown on this form is correct!

Your *monthly payment including taxes and insurance* is the amount you must pay every month for interest, repayment of loan principal, house insurance premiums, and property taxes. Expressed as a percent of your monthly income, this is called your housing expense ratio. Over time, in addition to any possible increases in your interest rate and how fast you must repay principal, your insurance premiums and property taxes will tend to increase. Of course, your monthly income may also increase. How much do you expect it to?

Your *fully-indexed housing expense ratio* is a key measure of whether you can afford this loan. It is the percent of your monthly income it will take to pay interest at the fully-indexed rate, plus repayment of principal, house insurance, and property taxes. The time-tested market standard for this ratio is 28 percent; the greater your ratio is, the riskier the loan is for you.

A *prepayment fee* is an additional fee imposed by the lender if you pay your loan off early. Most mortgages in America have no prepayment fee. If yours does, make sure you understand how it would work before you sign this form.

A "*balloon payment*" means that a large repayment of loan principal is due at the end of the loan. For

example, a seven-year balloon means that the whole remaining loan principal, a very large amount, must be paid at the end of the seventh year. This almost always means that you have to get a new loan to make the balloon payment.

A "*loan with possible negative amortization*" means that in the years immediately after securing a mortgage loan, you can pay even less than the interest you are being charged. The unpaid interest is added to your loan, so the amount you owe gets bigger. The very low payments in early years create the risk of very large increases in your monthly payment later. Negative amortization loans are typically advertised using only the very low beginning or "teaser" required payment, which is less than the interest rate. You absolutely need to know four things: (1) How long is the beginning payment good for? (2) What happens then? (3) How much is added to my loan if I pay the minimum rate? 4) What is the fully-indexed rate?

"*Points*" are a fee the borrower pays the lender at closing, expressed as a percent of the loan. For example, two points mean you will pay an upfront fee equal to 2 percent of the loan. In addition, mortgages usually involve a number of *other costs and fees* which must be paid at closing.

Closing is when the loan is actually made and all the documents are signed.

The *For Questions Contact* section gives you the name, phone number, and e-mail address of someone specifically assigned by your lender to answer your questions and explain the complications of mortgage loans. Don't be shy: contact this person if you have any questions.

Finally, *do not sign this form if you do not understand it.* You are committing yourself to pay large amounts of money over years to come and pledging your house as collateral so the lender can take it if you don't pay.

Ask questions until you are sure you know what your commitments really are and how they compare to your income. Until then, do not sign.

Appendix 4:

Historical Background on the Mortgage Insurance Industry: Lessons from the Great Depression

During the 1920s and early 1930s, a large volume of MBS (called mortgage certificates),[93] backed by mortgage guarantee companies, was sold to the public. By 1934, the mortgage certificates were in default and the guarantee companies had failed. The governor of New York (where most of the activity had taken place) appointed George Alger as commissioner to investigate the operation, conduct, and management of mortgage guarantee companies.[94] Commissioner Alger was specifically charged with "once again instilling public confidence in real estate as an investment." This is not unlike the challenge we face today as we endeavor to reform our housing finance market and re-instill investor confidence.

Commissioner Alger's report provides useful insights into both the causes of the most recent collapse and policy recommendations for avoiding a repeat occurrence. While it would be twenty-three years before any mortgage guaranty company would be formed in the United States,[95] Alger's recommendations formed the backbone of the state-based regulatory structure governing the formation and operation of mortgage guaranty insurance companies. This structure largely remains in place today and, in substantial measure, explains why the US mortgage guaranty insurance industry has largely survived intact, still paying claims and writing new business,[96] while Fannie Mae and Freddie Mac—along with many bond insurers, securities issuers, lending institutions, and private MBS—failed.

A few quotes from the Alger report demonstrate its relevance:

> "If . . . the sale of guaranteed mortgage certificates is again to be permitted, anything remotely resembling protection to the certificate holder must, I think, be based upon the doubly assured soundness of the guarantee itself. Our recent experience has shown us that this form of conducting the mortgage business is intrinsically hazardous and should not be permitted except upon the requirement of a ratio of capital funds to guaranties adequate to insure against another major depression, instead of the present complete absence of such requirement.

[93] For details on private-backed securities issuance volumes before World War II, see Kenneth A. Snowden, "The Anatomy of a Residential Mortgage Crisis: A Look Back at the 1930s" (National Bureau of Economic Research Working Paper 16244, Cambridge, MA, July 2010), www.nber.org/papers/w16244.pdf?new_window=1 (accessed March 22, 2011).

[94] Report to the governor of New York by Commissioner George Alger (Alger Report) regarding the operation, conduct, and management of mortgage guaranty corporations dated October 5, 1934. Document contained in the authors' files.

[95] The Mortgage Guaranty Insurance Corporation (MGIC) was formed pursuant to Wisconsin insurance law in 1957 by Max Karl. It remains the largest mortgage guaranty company in the United States.

[96] Going into the mortgage crisis there were seven companies. Six continue today and are paying claims and writing new business. Traid, the smallest of the seven, has ceased writing new business and is in run-off. It is paying claims at a reduced percentage and a final result is unknown. A new company, Essent, has formed since the crisis, returning the industry to seven members.

The business of guaranteeing mortgages is not an ordinary banking function, and the public would have been better off if none of the companies had owned or been affiliated with banking institutions, or in turn had not been owned by them."[97]

Commissioner Alger concluded that the mortgage guaranty business was subject to periods of boom and bust and that the MI industry had to be required by statute to put away reserves sufficient to be prepared for that event. A significant portion of the premium paid by borrowers in the boom years had to be locked up in reserves to be available to provide coverage during the inevitable bust years. This reserving had no relationship to the level of claims; in fact, that was the point—to put aside reserves during the fat years to be prepared for the lean. Accumulate a large enough reserve and it would be truly countercyclical. That is, it will act as a drag on over exuberance in the good years and be available to pay claims and provide capital to fund new business in the lean years.

Commissioner Alger made a series of recommendations for the regulation of "mortgage guarantee companies." These became the foundation of the modern mortgage guaranty industry established in 1957:[98]

1. "No other business to be done except the sale of guaranteed mortgages and mortgage and real estate servicing."
2. "No company, except with the consent of the superintendent of Banks, to invest in or own more than 10% of the stock of any company, or be itself more than 25% owned by any person, firm or corporation."
3. "The total of outstanding guarantees computed by taking the aggregate of 10% of the face amount of all outstanding mortgages guaranteed as to principal . . . shall at no times exceed the aggregate of capital and surplus."
4. "25% of capital and surplus to be set aside and earmarked as a guaranty fund, and invested and kept invested in bonds of the United States, or the state of New York, or other legal investments for trust funds (other than mortgages) approved by the Banking Department."
5. "Guarantees to be of first mortgages only."
6. "No mortgage to be guaranteed . . . which exceeds 2/3 of the appraised value of the real estate."[99]

He observed, "[u]nder no illusions of perfection, I entertain no faith that all risks of loss can be avoided in this field any more than any other field of investment. With adequate statutory safeguards, however, a fair approximation can at least be made to a system of general supervision over this basic form of investment.[100]"

---

[97] Report to the governor of New York by Commissioner George Alger (Alger Report) regarding the operation, conduct, and management of mortgage guaranty corporations dated October 5, 1934. Document contained in the authors' files.
[98] Within five years, a total of eleven private mortgage guaranty companies had been established under various state laws, all of which followed the Wisconsin regulatory structure.
[99] Report to the governor of New York by Commissioner George Alger (Alger Report) regarding the operation, conduct, and management of mortgage guaranty corporations dated October 5, 1934. Document contained in the authors' files.
[100] Ibid.

How is this experience from the 1930s relevant today? Mortgage lending presents three risks, two normal and one extraordinary. First, specific credit risks associated with the borrowers and their individual loan characteristics. This type of risk may be determined on an actuarial basis. Loans with small down payments or low FICO scores are riskier than those with larger down payments and higher FICO scores. These types of risks are largely uncorrelated (unless rules against concentration of risk are violated). Second, general economic risks associated with substantially increased unemployment, recessions, and other events that put stress on incomes, employment, and home prices. This type of risk may not be actuarially determined; instead stress tests based on worst-case depression scenarios are used. While these risks result in losses that are generally correlated; the impact can be kept manageable with sound underwriting and the accumulation of substantial reserves. The third risk is extraordinary. If lending standards become greatly weakened resulting in extraordinary levels of nonprime loans, specific loan-level risks become correlated and lead to a general collapse in loan performance. As a result, poor loan performance begins before any general triggering economic event such as a recession. It was the 27 million weak nonprime loans described in the main text of this white paper that led to the extraordinary mortgage meltdown that began while unemployment was under 5 percent.[101] This risk can be contained by setting a standard for a prime loan and measuring and limiting the accumulation of nonprime originations.

There are two risks that can be priced and reserved for:

- Actuarially determined risk-based pricing can price for known specific risks. For example, a 90 percent LTV loan is generally twice as risky as an 80 percent, an 80 percent twice as risky as a 70 percent, and a 70 percent twice as risky as a 60 percent. FICO score bands follow similar relationships.
- Sufficient reserves and capital to cover normal, general risks may be determined by stressing credit portfolios against the loan-default rates experienced during two extraordinary periods of risk (the Great Depression and the recent Great Recession). If structured properly, this counter-cyclical method of reserving has the potential to both reduce the size of the booms and busts and provide a source of capital needed to maintain prudent lending and liquidity during a crisis.

This approach has other salutary features relevant to the boom/bust nature of real estate lending. It is countercyclical since reserves are built during good times and available during times of stress. Further, by forcing industry participants to operate from 50 percent of their premium income, there is an even sharper focus on managing risk, keeping expense ratios low (including salaries), and paying sustainable dividend levels.

[101] US Department of Labor, Bureau of Labor Statistics, "Databases, Tables & Calculations by Subject," http://data.bls.gov/pdq/SurveyOutputServlet?data_tool=latest_numbers&series_id=LNS14000000 (accessed March 22, 2011).

Appendix 5:

Relative Foreclosure Rates

The following two tables set forth data from the 2005 Federal Reserve study. The first[102] covers loans from 1994 and demonstrates that it was well documented in 1996 that as FICO scores go down and/or LTVs increase,[103] the risk of foreclosure rises dramatically.

Table A5.1: Relative Foreclosure Rates by Credit Score Range (FICO >660 and LTV<=80% indexed to 1)

LTV	FICO <621	FICO 621–660	FICO >660
<=80%	26.9	7.9	1.0
>80%	47.6	15.3	3.3

The second covers both conventional and government fixed-rate loans from 1990 to 1993 and demonstrates that in 1996 it was well documented that as FICO scores decline, the risk of foreclosure increases dramatically for both types of loans.[104] Common sense dictates that forcing conventional lenders and investors to emulate government (that is, FHA) lending could only lead to disaster.

Table A5.2: Relative Foreclosure Rates for Conventional and Government Loans by Credit Score Range (FICO >660 and conventional fixed rate indexed to 1)

Loan type	FICO <621	FICO 621–660	FICO >660
Conventional fixed rate	28.5	7.3	1.0
Government fixed rate	45.0	12.8	3.0

These data date from the period before HUD began to increase affordable-housing requirements and encourage reductions in mortgage underwriting standards through the elimination of down payments, expansion of lending to credit-impaired borrowers, and other weakened lending standards. These efforts, taken pursuant to the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (GSE Act), forced the GSEs and the entire market to emulate the FHA's already high-risk lending, which got even riskier as the FHA further weakened its lending from the early 1990s onward.

102 Derived from Federal Reserve, Division of Research and Statistics, "Credit Risk, Credit Scoring, and the Performance of Home Mortgages," table 6. The index sets the average foreclosure rate equal to one for loans with a borrower FICO score of more than 660 and an LTV of <=80 percent. Data are from Freddie Mac over the period 1994–95.

103 The relationship between high-LTV and lower-LTV loans is understated by these data. In 1994, almost all of Freddie's loans had an LTV of 90 percent or less, with a small percentage having LTVs of 91–95 percent. Virtually none had an LTV >95 percent. As a result of HUD's mandates, Freddie (and Fannie) began acquiring 97 percent LTV loans in 1994 and 100 percent LTV loans in 2000.

104 Derived from Federal Reserve, Division of Research and Statistics, "Credit Risk, Credit Scoring, and the Performance of Home Mortgages," table 2. The index sets the average delinquency rate equal to one for conventional fixed-rate loans. Data are from the period 1990–93.

Appendix 6:

FHA lending

From its creation in 1934, the FHA has been one of Congress's main tools to support low- and moderate-income single-family housing. Since its establishment in 1934, the FHA has led the entire market to ever-higher LTVs and longer loan terms. The figures below[105] show LTV and mortgage term trends over the last sixty years:

Figure A6.1: Postwar Trends in New Home Mortgage Loan-to-Value Ratios, 1947–67

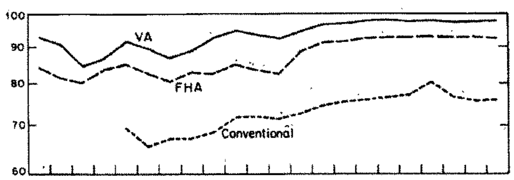


Figure A6.2: Postwar Trends in Existing Home Mortgage Loan-to-Value Ratios, 1947–67

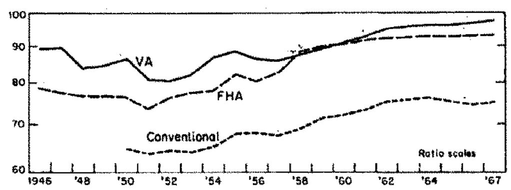
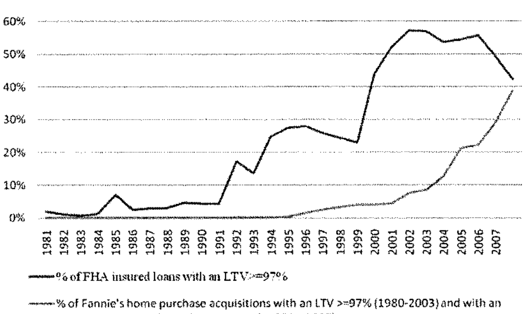
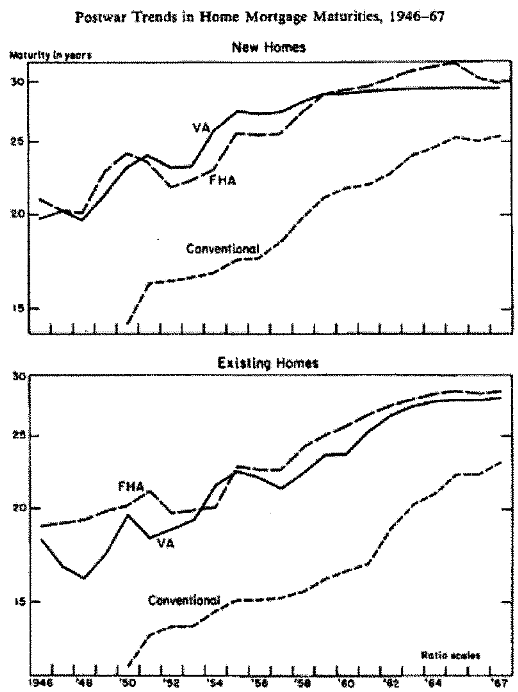


Figure A6.3: Trend of FHA and Fannie Loans with No Down Payments[106]



[105] John P. Herzog and James S. Earley, *Home Mortgage Delinquency and Foreclosure* (Cambridge, MA: National Bureau of Economic Research, 1970), www.nber.org/books/herz70-1 (accessed March 21, 2011).
[106] Edward J. Pinto, "Government Housing Policies in the Lead-Up to the Financial Crisis: A Forensic Study," chart 15.

Figure A6.4: Postwar Trends in New and Existing Home Mortgage Maturities, 1947–67



Beginning its operations during the Great Depression, the FHA admirably performed its role through World War II and the postwar boom. As noted, Congress periodically increased the FHA's LTV limit or extended its maximum loan term (or both). This was presumed to come at no cost and was likely justified on the basis of the FHA's previous experience. From 1934 through 1954, the FHA insured 2.9 million mortgages. For this period, during which house prices increased by 57 percent, the FHA paid claims on 5,712 properties for a cumulative claims rate of 0.2 percent[107] and had revenue of $494 million and expenses of $246 million.[108] The FHA's apparent success encouraged Congress to periodically loosen underwriting standards (see table A6.1).

---

[107] To put this in perspective, the FHA had twice this number of claims during the single month of October 2010. Federal Housing Administration, Department of Housing and Urban Development, "Monthly Report to the FHA Commissioner Department of Housing and Urban Development on FHA Business Activity," October 2010, www.hud.gov/offices/hsg/rmra/oe/rpts/com/10oct.pdf (accessed January 14, 2011).
[108] John P. Herzog and James S. Earley, *Home Mortgage Delinquency and Foreclosure.*

Table A6.1: FHA's Transition to Unsustainable Lending

Year	Maximum LTV limit	Maximum loan term	Monthly payment*	Homeowner equity after five years (with no increase in house prices)	Mortgage payment-to-income ratio	Income needed to buy median-priced home*
1934	80%	20 years	$670	30%	Not available	Not available
1938	90%[109]	25 years[110]	$695	17%	Not available	Not available
1948	90%	30 years	$660	14%	17% (average)	$26,600 income/ $44,600 home[111]
1956	95%	30 years	$697	10%	Not available	Not available
1984	97%	30 years	$712	8%	38% (maximum)[112]	$23,000 income/ $80,000 home[113]

* For comparison, all examples are based on the purchase of a $100,000 home at the maximum LTV and term with an interest rate of 8 percent, except for median-home-price calculation, which uses applicable median home price.

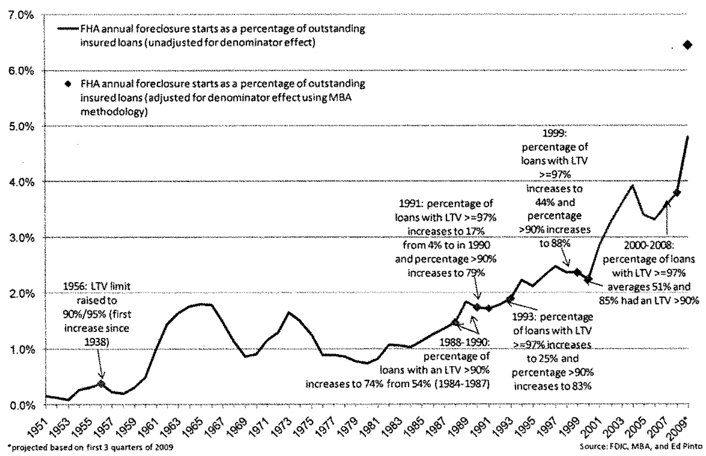
As seen from table A6.1, the FHA started out with both a substantial down payment (20 percent) and loan amortization, so by the end of the first five years of the loan, the homeowner had equity of 30 percent. Further, debt ratios were low. In the late 1940s, the FHA had an average mortgage-payment-to-income ratio of 17 percent.[114] By the early 1980s, a buyer would only have equity of about 8 percent after five years, and mortgage payments had about doubled relative to income.[115] Reliance on house-price inflation and lending to highly leveraged borrowers had become necessary parts of FHA's financing structure.

As figure A6.4 demonstrates, there was a cost. As FHA took on more risk, foreclosures increased.

---

[109] Ibid.
[110] Ibid.
[111] Median price data for 1950. See US Census Bureau, "Census of Housing," www.census.gov/hhes/www/housing/census/historic/values.html (accessed January 14, 2011).
[112] Stephen Moore, "How Congress Can Diffuse the Federal Housing Time Bomb," Heritage Foundation, July 29, 1986, 7, www.policyarchive.org/handle/10207/bitstreams/9281.pdf (accessed January 14, 2011).
[113] US Census Bureau, "Median and Average Sales Prices of New Homes Sold in United States," www.census.gov/const/uspriceann.pdf (accessed January 14, 2011).
[114] John P. Herzog and James S. Earley, *Home Mortgage Delinquency and Foreclosure*.
[115] Stephen Moore, "How Congress Can Diffuse the Federal Housing Time Bomb."

Figure A6.4: FHA's Increasing LTVs on Annual Foreclosure Starts as a Percentage of Insured Loans



By 1961, the FHA was experiencing a foreclosure start rate of 1.00 percent per year—over six times the rate in 1951.[116] Equally disconcerting was the fact that the private sector, in order to compete, followed the FHA's lead by increasing LTV, loan-term, and debt ratios.

As a result of the FHA's risky underwriting standards, its claim rate has been excessive for many decades. Over a thirty-five-year period (1975–2009), the FHA's cumulative claim rate averaged 10.5 percent, and over 1992–2009 it averaged 10 percent. Even during the boom years of 1995–2003, the cumulative claim rate still averaged nearly 8 percent. During bust periods (1980–85 and 2005–2008), it averaged 18 percent—over two times the rate in good times. For 2010–17, the FHA has projected an 8 percent average claim rate even with an expected 33 percent increase in home prices over 2011–20.[117] Relying on home-price inflation to attain a default rate of nearly one in ten is not sustainable lending.

[116] This increase led *Time* magazine to observe: "Homeowners of a new and unattractive breed are plaguing the Federal Housing Administration these days. Known as 'the walkaways,' they are people who find themselves unable to meet their mortgage payments—and to solve the problem simply move out their belongings at night, drop their house key in the mailbox and disappear." See "Credit: Beware of the Walkaways," *Time*, July 27, 1962, www.time.com/time/magazine/article/0,9171,827500,00.html (accessed January 14, 2011).
[117] FHA Actuarial Studies for 2010 and 2000.

PREPARED STATEMENT OF JANNEKE RATCLIFFE

SENIOR FELLOW, CENTER FOR AMERICAN PROGRESS ACTION FUND

TUESDAY, MARCH 19, 2013

Good morning Chairman Johnson, Ranking Member Crapo, and Members of the Committee. I am Janneke Ratcliffe, a Senior Fellow at the Center for American Progress Action Fund and the executive director for the Center for Community Capital at the University of North Carolina at Chapel Hill. I am also a member of the Mortgage Finance Working Group, a group of housing experts convened by CAP back in 2008 to chart a path forward for the mortgage market. The working group originally released our comprehensive "Plan for a Responsible Market for Housing Finance" back in January of 2011.[1] Since then, we have continued to offer comment on a variety of regulatory developments. While I will present recommendations from that plan, I speak only for myself today.

We are here today to discuss not just the future of the housing finance system, but the future of housing and economic opportunity for Americans. To quote from the Bipartisan Policy Commission, "restoring our Nation's housing sector is a necessary precondition for America's full economic recovery and future growth."[2]

As technical as this debate can be, we encourage you not to lose sight of the ultimate impact of the housing finance system on households, communities, and the economy. Research and our lived experiences confirm the link between housing and economic opportunity in this country, from the importance of decent and affordable rental housing and the many benefits of home ownership to the central role of the housing economy on economic vitality.

What I want to stress, and what the BPC report articulates so well, is that much of the benefit derived from housing depends on the way in which housing is financed. That is why, since 1932,[3] the Government has sought to foster a mortgage marketplace that is stable, safe, efficient and affordable. One visible hallmark of Government's involvement is the long-term fixed-rate mortgage. Partly as a result, home ownership has served as a crucial building block of a strong middle class in the 20th century.[4] The mechanisms have evolved over time and in response to crises, from the creation of the Federal Home Loan Bank System and Federal deposit guarantees to the more recent bailouts of private institutions and the conservatorship of the Government-Sponsored Enterprises. Now we have the opportunity to put in place a system that will serve the next generations even better than the systems that have preceded it.

The State of the Housing Market Today

As the market struggles to right itself, I suggest we remain mindful of the urgency and importance of the task ahead. Our national mortgage market today is significantly smaller than it was in the early 2000s.[5] The homeownership rate has dropped from close to 70 percent to 65 percent,[6] and while the housing market's recent performance is heartening, we fear the fundamentals are not yet there for a robust, accessible and sustainable market to develop.

To start, approximately three quarters of mortgage originations in 2012 were refinances, not home purchases.[7] Among the purchases that are occurring, the National Association of Realtors estimates that investors represented 20 percent in 2012, high above their historic norm of 10–12 percent.[8] This investor presence may support housing prices and perhaps even inflate them,[9] but will not necessarily sta-

---

[1] Mortgage Finance Working Group, "A Responsible Market for Housing Finance" (Washington: Center for American Progress, 2011), available at *http://www.americanprogress.org/issues/housing/report/2011/01/27/8929/a-responsible-market-for-housing-finance/*.

[2] Bipartisan Policy Center Housing Commission, "Housing America's Future: New Directions for National Policy," (2012), available at *http://bipartisanpolicy.org/library/report/housing-future*.

[3] See the Federal Home Loan Bank Act, Pub.L. 72–304, 47 Stat. 725.

[4] Bipartisan Policy Center Housing Commission, "Housing America's Future".

[5] U.S. Department of Housing and Urban Development, "U.S. Housing Market Conditions Historical Data," available at *http://www.huduser.org/portal/periodicals/ushmc.html*.

[6] Ibid.

[7] U.S. Department of Housing and Urban Development and U.S. Department of Treasury, "The Obama Administration's Efforts to Stabilize the Housing Market and Help American Homeowners," (2013), available at *http://portal.hud.gov/hudportal/documents/huddoc?id=HUDJanNat2013SC_FINAL.pdf*.

[8] National Association of Realtors Realtor Confidence Survey, available at National Association of Realtors Realtor Confidence Survey.

[9] Susan Berfield, "What Crash," Bloomberg Businessweek (March 2013).

bilize neighborhoods or pave the way for move-up buyers or home ownership in the future.

In the meantime, first-time home buyers, young home buyers and home buyers of color—the future of home ownership in the United States[10]—have largely been shut out of the conventional mortgage market. The Federal Housing Administration backed financing for 46 percent of first-time buyers in 2012 and about half of home purchases obtained by home buyers of color in 2011.[11] Homeownership rates for young people (ages 25–34) are among the lowest in decades.[12] This decline in home ownership has led to an increase in renters. With rents rising, this is only putting more pressure on the Nation's renters, more than half of whom are "rent impoverished," or spending more than one-third of their income on housing.[13] These figures do not suggest well-functioning single and multi-family housing finance markets.

What's more, it has now been close to 5 years since Fannie Mae and Freddie Mac went into conservatorship. The GSEs are slowly deteriorating, with no clear plan for a restructured secondary market. In the absence of direction from Congress, the Federal Housing Finance Agency is unilaterally making significant policy decisions and investments. Some of these we support, and some we oppose. For example, of the decisions that have been disclosed by the agency, we agree that it makes more sense to invest in a single securitization platform for the mortgage giants rather than to retool the companies' own systems, while we strongly disagree with the decision not to pursue some form of principal forgiveness for delinquent loans or the decision to not fund the Affordable Housing Trust fund or Capital Magnet Fund. Other important decisions are not even to be found in the strategic plans, and are opaque to the public, such as decisions regarding how and when to extend credit to first-time home buyers.

But it doesn't matter whether we agree or disagree. What matters is that these decisions will impact American families broadly whether they own their home, hope to become homeowners someday, or are seeking affordable rental options-and will lay the foundation for the shape of the market for many years to come. I believe these decisions are far too important to leave to one single agency whose deliberations largely take place behind closed doors, and whose officials are not elected, appointed, or confirmed.

A Bipartisan Way Forward

It is time to set a clear direction for the future state of the mortgage secondary market—one that considers the interests of all stakeholders, and does so in the context of broader, long-term considerations and priorities.

You've asked whether there is a bipartisan way forward on housing finance reform. There is. The Bipartisan Policy Center's housing recommendations are based on a view shared across the political spectrum that home ownership is a desirable option when viable, and that those who do not buy a home ought to have access to affordable, quality rental housing.[14] More specifically, this group agrees that the 30-year, fixed-rate product is the gold standard for a safe and sustainable mortgage market; that there is a critical need for a reformed multi-family finance system to meet the demand for affordable rental; and that the system must provide access to safe and affordable mortgages for all creditworthy borrowers, including those of low and moderate income.

Perhaps most important, the bipartisan plan recognizes the need for the Government to retain a guarantor role in the core portion of the GSE-supported market going forward. At this point, the Bipartisan Policy Center's reform plan is one of 18 proposals (including several bipartisan ones) that call for some explicit Government support for the segment of the market traditionally served by the GSEs, while only a few plans propose no Government role beyond FHA.[15]

---

[10] George S. Masnick, Daniel McCue, and Erick Belsky, "Updated 2010–2020 Household and New Home Demand Projections," Working Paper W10–9 (Harvard Joint Center for Housing Studies, 2010), available at *http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/w10-9_masnick_mccue_belsky.pdf.*

[11] National Association of Realtors, "Profile of Home Buyers and Sellers 2012" (2012); FHA Annual Report to Congress Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund, available at *http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf.*

[12] HUD, "U.S. Housing Market Conditions Historical Data".

[13] United States Census Bureau, American Housing Survey.

[14] Bipartisan Policy Center Housing Commission, "Housing America's Future".

[15] For a summary of plans, see John Griffith, "The $5 Trillion Question: What Should We Do with Fannie Mae and Freddie Mac?" (Washington: Center for American Progress, 2013), available at *http://www.americanprogress.org/wp-content/uploads/2013/03/NewGSEReformMatrix.pdf.*

In other words, while a couple of outlier proposals still call for withdrawal of all support, we see a very broad consensus emerging. It is time to move on from this question because ironically, until we do so, the Government will continue to provide a 100 percent guarantee for the vast majority of mortgages.

The Commission's recommendation is a critical first step, but it is just a beginning. Now it is time to have a robust, in-depth conversation about how to structure the secondary mortgage market with an explicit, paid for and actuarially sound Government backstop.

For these reasons, I'm very excited about today's hearing, and I hope it signals Congress's readiness to enter into a serious conversation about re-visioning our housing finance system.

Principles of a Responsible Housing Finance System

In 2008, the Mortgage Finance Working Group brought together experts to collectively strengthen their understanding of the causes of the crisis and to discuss possible options for public policy to shape the future of the U.S. mortgage markets. The Group's vision of a well-functioning and responsible market that protects taxpayers is grounded in five principles similar to those that underpin the proposal of the Bipartisan Policy Commission: liquidity, stability, transparency, access and affordability, and consumer protection.

Liquidity: The system needs to provide a reliable supply of capital to ensure access to mortgage credit for both rental and homeownership options, every day and in every community, during all kinds of different economic conditions, through large and small lenders alike. The capital markets have come to play an essential role in mortgage finance, but as the past decade so stunningly demonstrated, capital markets on their own provide highly inconsistent mortgage liquidity, offering too much credit sometimes and no credit at other times. These extremes can have a devastating impact on the entire economy.

Stability: Private mortgage lending is inherently procyclical. Stability for the market requires sources of countercyclical liquidity even during economic downturns. For families, stability means that they will not experience wild fluctuations in home values, allowing them to plan financially for their families, education, businesses, or retirement. Stability also requires sustainable products and capital requirements that are applied equally across all mortgage financing channels for the long cycle of mortgage risk. As we saw in the previous decade, capital arbitrage can quickly turn small gaps in regulatory coverage into major chasms, causing a "race to the bottom" that threatens the entire economy.

Transparency: Underwriting and documentation standards must be clear and consistent across the board so consumers, investors, and regulators can accurately assess and price risk and regulators can hold institutions accountable for maintaining an appropriate level of capital. Secondary market transparency and standardization lower costs and increase availability, and are a fundamental precondition for the re-emergence of a private mortgage-backed securities market.

Access and Affordability: The lower housing costs produced by the modern mortgage finance system (before the recent crises) helped more families become homeowners, which enabled them to live in a stable community, to build equity, and to pass on assets to their heirs. Similarly, the Government-backed mortgage finance system has provided developers of affordable multifamily rental housing with a source of long-term, fixed-rate mortgages, while the purely private market prioritizes market-rate rental housing.[16] The Government guarantees, along with associated regulatory and consumer protections, confer significant benefits to households who can access it—and that should include all credit-worthy borrowers. Left to its own devices, participants tend to "cream" the market, leaving perfectly credit-worthy lower wealth, lower income or minority segments underserved. With appropriate incentives and tools, these segments can be well-served, to the benefit of the entire system.

Consumer Protection: The purchase of a home is a far more complicated, highly technical transaction than any other consumer purchase and occurs only a few times in a consumer's life. Mortgage consumers are at a severe information disadvantage compared to lenders. In addition, a mortgage typically represents a household's largest liability. As the current crisis has demonstrated, consumer protection is inextricably linked with financial institution safety and soundness. Along with regulators such as the Consumer Financial Protection Board, any structure supporting

---

[16] Ethan Handelman, David A. Smith, Todd Trehubenko, "Government-Sponsored Enterprises and Multifamily Housing Finance: Refocusing on Core Functions," (Washington: National Housing Conference, 2010), available at *http://www.nhc.org/media/files/NHC_GSE_core_functions_v8_2_101001.pdf.*

the Nation's housing market must share a commitment to ensuring that the system supports rather than undermines the financial health of the consumer.

Basic Structure of Our Proposal

The Mortgage Finance Working Group's proposal creates a system that preserves the traditional roles of originators and private mortgage insurers, but assigns functions previously provided by Fannie Mae and Freddie Mac to three different actors: (1) issuers; (2) chartered mortgage institutions, or CMIs; and (3) a catastrophic risk insurance fund. Our plan seeks to use the least and most remote public guaranty necessary to leverage the greatest amount of private capital in a first loss position, which in turn will provide interest rate investors the assurance to fund long-term mortgages.

Issuers: Issuers are purely private entities that originate or purchase and pool loans and issue mortgage-backed securities (MBS).

Chartered Mortgage Institutions (CMIs): Issuers will purchase credit insurance on MBS that meets certain standards from CMIs. These entities also will be fully private institutions, but will not be owned or controlled by originators. They will be chartered and regulated by a Federal agency and their function would be to assure investors of timely payment of principal and interest on those securities that can qualify to be covered by the Catastrophic Risk Insurance Fund.

Catastrophic Risk Insurance Fund (CRIF): This on-budget fund would be similar to the FDIC's Deposit Insurance Fund, *i.e.,* run by the Government and funded by premiums on CMI-guaranteed MBSs. In the event of a CMI's financial failure, the explicit guarantee provided by the CRIF would protect the holders of qualified CMI securities. The Government would price and issue the catastrophic guarantee, collect the premium, and administer the fund. The fund would establish the product structure and underwriting standards for mortgages that can be put into guaranteed securities and the securitization standards for MBSs guaranteed by the CMIs, and also establish reserving and capital requirements for CMIs that would be at higher levels than those presently held by Fannie and Freddie. In addition, the CRIF would regulate pooling and servicing standards to ensure a liquid market for the MBS and appropriate treatment of delinquent loans to protect the fund and consumers.

Under our plan, there will be several layers of protection standing ahead of the CRIF: borrower equity, the CMI's capital, and in some cases private mortgage insurance. All of these private sources of funds would need to be exhausted before the CRIF would have any exposure to loss. And the CRIF would have to fail before any taxpayer funds would be required to meet the Government's guarantee to security holders.

In addition, to provide tools that encourage safe and sound innovation and access, we propose establishment of a "Market Access Fund" which would support research and development, provide limited credit enhancements, and offset the costs of support services such as housing counseling. This fund would be supported by a per-loan contribution from all securitized loans, as the entire system benefits from the provision of prudent and affordable lending to enable more households to advance up the housing ladder. In addition, the Capital Magnet Fund and the National Housing Trust Fund, both of which were created in 2008 and intended to be funded by Fannie Mae and Freddie Mac, would become funds within the Market Access Fund.

Comparing our Proposal to Other Proposals

In your invitation to testify today, you identified the essential objectives policymakers should aim for as they seek to structure the future mortgage markets: the continued availability of the standard affordable long-term fixed-rate mortgage, equal access to the secondary market for all lenders, equal access for all qualified borrowers and market segments, availability of stable liquid and efficient funding for both multi-family and single-family housing, the protection of taxpayers, and the impact on economic recovery and stability.

A comparison of our plan with others illustrates several considerations for how to structure a well-functioning secondary mortgage market that achieves these objectives.[17] Our proposal is just one of many proposals, including the proposal of the Bipartisan Policy Commission, recognizing the need for Government support of the core mortgage market. Although there are differences in the structural details, such

[17] For a side-by-side comparison and links to 22 plans, see matrix on CAP Web site at *http://www.americanprogress.org/wp-content/uploads/2013/03/NewGSEReformMatrix.pdf.*

proposals share the common principals of liquidity and stability that are required for a well-functioning housing system.

Preserve the standard affordable long-term fixed-rate mortgage

The explicit Government guaranty—even a remote one, such as our plan calls for—preserves the long-term, self-amortizing, fixed-rate mortgage, which maximizes affordability and economic security for the majority of American homeowners.

This type of mortgage, which is generally a 30-year, fixed-rate mortgage, provides borrowers with cost certainty regardless of market conditions. Adjustable rate mortgages expose borrowers to interest rate risk. Shorter-duration products with balloon payments that are designed to be refinanced every 2 to 7 years expose borrowers not only to ordinary interest-rate risk, but also to the risks that they may not be able to refinance when they need to due to other adverse changes in market conditions.

Research conducted at the UNC Center for Community Capital confirms the important role that safe and sustainable products play in making home ownership work better for more households. A longitudinal study of nearly 50,000 families, with a median income of around $35,000 who purchased homes in the decade leading up the bubble and bust, has found relatively low default rates, despite the fact that most of these borrowers put down less than 5 percent on their home purchase and about half had credit scores below 680. Although these borrowers would be very unlikely to get approved for a mortgage in today's tight market, they turned out to be good credit risks even through a major recession, and they even managed to build some equity at the median. These loans were prime-priced, fully underwritten loans, extended by banks around the country and sold to Fannie Mae.[18] Comparison with similar borrowers receiving adjustable-rate and other nontraditional loan features via the purely private market, who defaulted at rates three to five times as high, highlights the important role that good products play in reducing credit risk.[19]

Providing borrowers with that kind of stability also has benefits for the economy as a whole. Prior to the introduction of the major housing and finance reforms of the 1930s, the United States had a mortgage system that closely resembled the purely private system conservatives are arguing for today. Mortgages were typically for a term of 5 years and depended on regular refinancing.[20] That system failed spectacularly when the Great Depression hit and half of all homeowners defaulted on their mortgage (although foreclosure rates remained lower than today due to the Government's creation of the Home Owners' Loan Corporation).[21]

Without Government involvement of some kind, the 30-year, fixed-rate mortgage is likely to be a product of the past.[22] Some have asserted that the significant development of the financial sector since the 1930s means that a purely private mortgage system could effectively serve the mortgage needs of Americans today. They point to the nascent recovery in the so-called jumbo mortgage markets, an area that lacks any Government support because these mortgages are for the high end of the housing market, as evidence supporting the idea that the purely private markets can capably serve the mortgage markets.[23]

However, the fact that the purely private markets may be able to meet the mortgage needs of a small, wealthy slice of home buyers does not mean that they will be able to meet the mortgage needs of all Americans. This argument ignores the limited investor appetite for long-term debt investments—the type of investments

[18] Roberto G. Quercia, Janneke Ratcliffe, and Allison Freeman, *Regaining the Dream How to Renew the Promise of Homeownership for America's Working Families* (Washington: Brookings Institute Press, 2011).

[19] Lei Ding, Roberto G. Quercia, Wei Li, and Janneke Ratcliffe, "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models,"Journal of Real Estate Research 33 (2) (2011): 245–278, available at *http://www.ccc.unc.edu/documents/Risky.Disaggreg.5.17.10.pdf.*

[20] Richard K. Green and Susan M. Wachter, "The American Mortgage in Historical and International Context," Journal of Economic Perspectives 19 (4) (2005): 93–114, available at *http://papers.ssrn.com/sol3/papers.cfm?abstract__id=908976.*

[21] David C. Wheelock, "The Federal Response to Home Mortgage Distress: Lessons from the Great Depression," Federal Reserve Bank of St. Louis Review 90 (3) (2008), pp. 133–48, available at *http://research.stlouisfed.org/publications/review/08/05/Wheelock.pdf; Green and Wachter, "The American Mortgage in Historical and International Context."*

[22] Richard K. Green, Testimony before the Senate Banking Committee, "Housing Finance Reform: Should there be a Government Guarantee?" September 13, 2011, available at *http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore__id=56068079-9c03-40d4-b36a-72913d3850b4.*

[23] Peter Wallison, "Going Cold Turkey," (Washington: American Enterprise Institute, 2010), available at *http://www.aei.org/outlook/economics/financial-services/housing-finance/going-cold-turkey/.*

that fund home mortgages-in the absence of a Government backstop. While investor demand for long-term sovereign debt is enormous, totaling many trillions of dollars for U.S. Treasuries alone, the demand for privately issued long-term mortgage obligations that don't carry a Government backstop is small in comparison.[24] What's more, the jumbo market is enabled by the existence of the conventional market, as lenders need to compete with a product that wealthier borrowers could access with a larger downpayment. The conventional market also provides transparent pricing information and benchmark prices and rates that the jumbo market can piggyback on.

As noted, any plan that maintains a Government guaranty will give a broad class of investors the confidence to invest in the U.S. housing finance system at efficient, fixed rates. In our view, similar to the proposal of the Bipartisan Policy Commission as well as several others, this Government guaranty needs only to cover the catastrophic level to serve this function as well as to support the TBA market,[25] provided there is sufficient standardization. Proposals that call for the investors to share in some tail risk are unlikely to achieve this end. On the other hand proposals that call for the Government to take a larger share of the risk, for example through a single, Government-owned entity that takes both predominant and catastrophic risk (similar to the way the GSEs are functioning now, or FHA and Ginnie Mae combined) may result in marginally greater efficiencies to the extent that greater homogeneity drives greater liquidity. For example, even today, with full Government support, Fannie Mae and Freddie Mac securities do not trade the same.

Ensure that both large and small lenders have access to secondary market finance to help ensure broadly available access to credit in all communities.

A diverse lending market is crucial for ensuring broad access to credit for all borrowers and communities, including rural communities, communities of color, and communities that have been hard-hit by the recession. A secondary market that enables lenders of all sizes in all communities to offer mortgages on equal and well understood terms is one of the major beneficial functions of Fannie Mae and Freddie Mac that, going forward, the reformed system must retain and even improve on.

Our proposal recognizes the risks of building a system that favors large, well-capitalized banks (and their affiliates) and leaves small originators at the mercy of their larger competitors as to whether and under what terms they can access the Government-guaranteed market. In our proposal, multiple chartered mortgage institutions (CMIs) would perform the predominant credit risk-taking function of Fannie and Freddie. These entities would enhance competition and ensure equal access by small lenders to the secondary market. Originating lenders would not be allowed to own a CMI, except as part of a broad-based mutually owned entity designed to ensure access at equitable prices to smaller lenders such as community banks, credit unions and community development finance institutions. In that context, and to assist in the achievement of public policy outcomes that may not coincide with the interests of private owners of CMIs, consideration might also be given to permitting CMIs established by Government entities, such as housing finance agencies, individually or collectively.

Some proposals would explicitly allow banks and originators to perform the predominant credit risk-taking function. In a marketplace already characterized by extreme concentration of origination and servicing in entities that have both explicit Government guarantees (on deposits) and implicit guarantee ("too big to fail"), this structure would only extend the large banks' market power and encourage the accumulation of risk with an implicit Government guaranty. In effect it would be recreating Fannie and Freddie, except under the control of the largest originators. While proponents point to the Ginnie Mae model where originators are also issuers, they ignore the fact that the credit risk-taking function is not provided through Ginnie Mae or the issuers, but through FHA on a per-loan basis, universally available on equal terms. In the case where issuers themselves are determining the risk param-

[24] Bryan J. Noeth and Rajdeep Sengupta, "Flight to Safety and U.S. Treasury Securities," The Regional Economist 18 (3) (2010):18–19 available at *http://www.stlouisfed.org/publications/re/articles/?id=1984;* see also Ben S. Bernanke, "Housing, Housing Finance, and Monetary Policy," August 31, 2007, available at *http://www.Federalreserve.gov/newsevents/speech/bernanke20070831a.htm.*

[25] The TBA, or "To be Announced," market is a type of futures market for mortgage-backed securities that allows lenders to provide consumers with interest rate forward commitments or "locks" on their mortgage interest rates before the final mortgage is signed and sealed. For more information on the importance of the TBA market, see Mortgage Finance Working Group, "A Responsible Market for Housing Finance".

eters and pricing for the predominant credit risk, such a transparent and level playing field will be hard to achieve.

Some of those proposals do identify this market power risk but would manage it administratively rather than structurally. Such plans would prohibit discriminatory pricing by issuers or credit-risk-takers. For example, the BPC plan calls for the Public Guarantor to set rules of the road that would prevent issuers (who are charged with choosing how to cover the credit risk) from creating "barriers using differential guarantee-fee pricing or other means to unfairly restrict or disadvantage participation in the Government-guaranteed secondary market."[26] However, managing that risk administratively may be easier said than done.

By contrast, cooperatively owned and "utility" models deliberately seek to equalize small lender access through structural mechanisms. At the far end of the spectrum, proposals that call for a single entity such as a nationalized secondary market would go even further to minimize this risk.

Ensure that all creditworthy borrowers and market segments have access to the mainstream housing finance system.

As noted previously, many of the benefits we associate with stable and affordable housing options stem from the way in which that housing is financed. Left to its own devices, the market will tend to deliver the best loans where it is easiest to do so and to channel higher cost loans where borrowers are easier to exploit and have fewer options. Such cherry-picking practices result in the benefits flowing primarily to private shareholders and to a narrow group of advantaged borrowers, rather than the economy as a whole. To further the goal of access and affordability, CMIs in the new housing finance system would be responsible for providing an equitable outlet for all primary market loans meeting the standards for the guarantee, rather than serving only a limited segment of the business, such as higher-income portions of that market.

This obligation would have four parts:

- CMIs would be expected to mirror the primary market (roughly) in terms of the amount and the geography of single-family low- and moderate-income loans (other than those with direct Government insurance) that are securitized and are eligible for the CMI guarantee. They would not be allowed to "cream" the market by securitizing limited classes of loans. (This approach relies on effective implementation of the Community Reinvestment Act, which requires banks and thrifts to serve all communities in which they are chartered; note that the Community Investment Act likely requires some updating for it to function optimally, and the Federal banking regulators have been engaged in a lengthy process to do this.)
- CMIs that guarantee multifamily loans would be expected to demonstrate that at least 50 percent of the units supported by securitized multifamily loans during the preceding year were offered at rents affordable to families at 80 percent of the relevant area median income, measured at the time of the securitization.
- CMIs would be required to provide loan-level data on securitizations to the Government (which will be required to make these data public) that are more robust than those of the Public Use Database currently produced by the Federal Housing Finance Administration.
- All CMIs would participate in a yearly planning, reporting, and evaluation process covering their plans for and performance against both the single-family and multifamily performance standards and Government-identified areas of special concern, such as rural housing, small rental properties, and shortages created by special market conditions such as natural disasters.

Like all other secondary market participants, CMIs would be required to abide by nondiscrimination and consumer protection laws. Substantial underperformance by a CMI could lead to fines and possible loss of its CMI license.

Provide credit enhancement or other programs to serve those who cannot be served by purely private markets.

While rules against discriminatory lending and anti-creaming provisions, such as those we have proposed for CMIs, will help, they will not fill all the gaps left by a national history of discrimination and wealth disparities. These gaps are especially important to fill in the aftermath of the housing crisis, where many communities saw equity stripped by subprime lending or were hit very heavily by the recession and unemployment. These neighborhoods most in need of capital to rebuild

[26] Bipartisan Policy Center Housing Commission, "Housing America's Future," p. 57.

likely will be the last to get it from a private market left to its own devices. The Community Reinvestment Act is too limited in scope to be expected to generate the level of support required solely through banks' balance sheet lending.

However, many prospective homeowners and owners of rental homes who are not easily served by private markets demanding competitive rates of return can be well served with limited amounts of credit enhancement, or "risk capital." These borrowers inhabit a "grey zone" between fully private credit and fully insured credit through agencies like the FHA, VA and USDA's Rural Housing Services (RHS). During their most effective years, Fannie Mae and Freddie Mac generated some of this innovation through their own risk capital by relying on standard, fully documented loans; their large market shares; and broadly priced credit products, using limited pilots or trusted partners Banks subject to the Community Reinvestment Act also do some of this on a limited scale, both internally and through support of mission-oriented intermediaries such as Community Development Financial Institutions (CDFIs).

We therefore propose establishment of a Market Access Fund, which would have three broad functions:

- Provide support, both grants and loans, for research, development and pilot testing of innovations in product, underwriting and servicing geared to expanding the market for sustainable home ownership and for unsubsidized affordable rental.
- Provide limited credit enhancement for products that expand sustainable home ownership and affordable rental but that, without such credit enhancement, cannot be piloted at sufficient scale to determine whether they can be sustained by the private market, or, alternatively, are best served by FHA, VA and/or USDA or by the States.
- Provide incentive grants to encourage development of self-sustaining support services, such as housing counseling, that have proven effective in expanding safe and affordable home ownership, but that so far have not developed a sustainable business model that combines lender support, client fees and limited Government and philanthropic subsidy.

We propose that the Market Access Fund be funded through a small (*e.g.,* 10 basis points) assessment on all securitized mortgages, whether or not an issue receives a Federal catastrophic guarantee. The fee would be structured as a "strip" from the mortgage coupon, in the same way that servicing fees are charged, and would continue for the life of the mortgage. This fee could be easily collected by the SEC on behalf of the Fund, or, if proposals for a single mortgage backed securities platform are implemented, by the platform.

The Fund should be on-budget, allowed to grow over time, and its credit activities subject to credit scoring. Using 2000 as a "normal" year for mortgage-backed securities issuance, a 10 basis point assessment would generate approximately $630 million annually while only costing individual mortgage borrowers a negligible amount—about $250, or about $20 per month, on a $250,000 mortgage. Assuming mortgage backed securities remain outstanding for an average of 4 years and MBS issuance remain at the 2000 level, by the fifth year after initiation, the fee would be generating a steady revenue of $2.5 billion.

By creating and using the Market Access Fund in this manner, all participants in the mortgage market will be contributing to the stability of that market and of the economy. That will be a marked contrast to the pre-crash system in which the so-called private market was able to use the credibility and stability of the U.S. capital markets to simultaneously abuse lower wealth borrowers and communities and make huge profits.

In addition, the Capital Magnet Fund and the National Housing Trust Fund, both of which were created in 2008 and intended to be funded by Fannie Mae and Freddie Mac, would be relocated within the Market Access Fund. The National Housing Trust Fund allows the States to expand the supply of rental housing for those with the greatest housing needs. The Capital Magnet Fund enables CDFIs and nonprofit housing developers to attract private capital and take affordable housing and community development activities to greater scale and impact.

Several other plans, including that of the Bipartisan Policy Commission, recognize the value of access and affordability in principal. There are plans that call for the secondary market entity(s) to maintain a portfolio—at a much smaller scale than Fannie and Freddie—for the purpose of funding niche and harder-to-securitize loans that expand access and affordability for single-family or affordable multi-family activities.

However, to our knowledge, no other plan spells out specific mechanisms for proactively ensuring broad access for all qualified, creditworthy households to the mainstream mortgage market, rather than to FHA. Other proposals call for all low- and moderate-income lending to be served through the FHA. This approach ignores the fact that much of this segment can be well and safely served by the core conforming conventional market, and that the primary market's conventional lending to such segments, through CRA and otherwise, depends on a reliable secondary market outlet. Instead, it would institutionalize a dual mortgage market, with less choice and higher costs for borrowers who would most benefit from access to the prime conventional market, and it would unnecessarily and inefficiently drive credit risk onto the Government's balance sheet.

We argue that access and affordability objectives can be achieved whether the GSEs are replaced by numerous private credit-risk takers, a public utility, or a nationalized secondary market. That said, the more centralized the credit-risk-taking entity (s), and the more authority it has, the easier it is to align the delivery of the guaranty with broader housing policy objectives.

Provide access to reasonably priced financing for both home ownership and rental housing so families can have appropriate housing options to meet their circumstances and needs.

The need for affordable housing is growing more urgent for families in the United States. Over half of U.S. households spend more than 30 percent of their income on housing, and one in four U.S. households spends over half of its income on housing. We applaud the attention paid by the Bipartisan Policy Commission to the crisis in affordable rental housing for working-class households, a segment that is not effectively served today by either the Government or the private market.

Our plan will address the affordability crisis by supporting broad access to affordable mortgage credit in the multi-family markets. The Mortgage Finance Working Group's plan uses a carefully deployed and targeted Government guarantee to encourage private capital to bear risk ahead of the Government for affordable multifamily finance as well. We envision that CMI's, most likely specializing in multifamily, would take predominant risk ahead of the CRIF for permanent financing. These CMI's would be required, on an annual basis, to demonstrate that 50 percent of the units financed by securities it guarantees are affordable to a family making 80 percent of median income.

Some alternative proposals are silent on multifamily finance, or eliminate a Government guarantee, or call for splitting the secondary market for multifamily off from that of the single-family market. But any responsible plan must address the critical gaps in financing for affordable rental properties, a goal which has gone too long ignored in U.S. housing policy.

Protect taxpayers from unnecessary risk

The Mortgage Finance Working Group envisions a system that is capitalized with as much private capital at risk as possible while still serving the Nation's housing needs. That will require Federal Government support, but only in a remote, catastrophic-backstop position, one that is well-buffered by several layers of private capital. The first layers of risk would be absorbed by owners' equity and, on lower-downpayment loans, by traditional private mortgage insurance. The next layer—what the Bipartisan Policy Commission refers to as the predominant credit risk—would be borne by private institutions specifically chartered for that purpose (CMIs). These entities would be regulated to hold adequate capital and reserves, and subject to strict standards for risk management. The next layer, which would be accessed only after failure of a CMI, would be covered by the Catastrophic Risk Insurance Fund, similar to the FDIC's Deposit Insurance Fund. This guarantee will be paid for by premiums set at rates designed to cover losses should a CMI fail. The Government guaranty of MBS would be specific and limited to investments in qualified mortgage backed securities, and would not protect the shareholders or creditors for the CMIs.

At a high level, our plan is similar to the Bipartisan Policy Commission and several others that call for private capital in the predominant loss position with a fund standing behind that. Analysis presented by the Bipartisan Policy Commission finds that a 4 to 5 percent aggregate loss cushion would absorb credit losses in a scenario of the severity just experienced (with a 30 to 35 percent decline in house prices) (p56). This cushion is a massive increase over the old minimum capital require-

ments on Fannie and Freddie of .45 percent on credit risk.[27] All these plans recognize that mortgages would cost somewhat more, but estimate that the net effect will not be of a magnitude that would disrupt the market.

However, these plans differ as to the form that private capital would take. Some, like ours, call for specialized monoline institutions, while other plans envision a role for structured transactions. In my view, the institutional solution has significant advantages. It is easier to regulate and manage for safety and soundness, and it is more efficient at pooling and spreading risks. Structured transactions, to the extent that they cover a single or limited number of pools, cannot provide the benefit of a secondary market that can allocate risks and reserves across years, regions, lenders, and so on. The structured transactions approach also tends toward greater complexity and less transparency for purposes of pricing and regulation.

Of course, for all these private-risk-capital proposals, one big unknown is whether and at what terms adequate private capital will be available. Under plans that call for a smaller role or no role at all for private capital, this question is of course less important.

Promote economic recovery and housing market stability

A healthy mortgage secondary market is required for a healthy economy. This is true both with regard to shorter-term economic stability, and long-run stability.

In the short term, uncertainty about the future state will continue to dampen lending activity, creating a self-fulfilling drag on recovery. At the same time, though, our tentative recovery would be derailed by disruptions to the current state. The Bipartisan Policy Commission calls for a congressionally adopted model coupled with a "dynamic, flexible transition" for winding down the GSEs and moving toward the new model. The transition may take 5 to 10 years, and it can be eased by building the new model on the valuable infrastructure currently residing with Fannie and Freddie. This approach will help the market recover and transition to a new normal.

We also must keep our eye on long-term economic stability, which derives from appropriate Government support of financial systems. While our plan calls for private capital to bear all but tail risk, we also recognize that the more central a role is played by private capital, the more instability is introduced. Private capital is inherently procyclical, meaning that it tends to be plentiful and cheap during good times and scarce and expensive during downturns, thus inflating bubbles and deepening downturns. While this is a challenging problem, we suggest that there are two keys to solving it.

The first is to build in countercyclical capability in an intentional and effective way, through a series of dials that can be adjusted in times of economic stress when private capital simply flees. In addition to ramping up FHA activity, the other moving dials could include regulatory interventions and a shift in split of risk bearing. Our plan explicitly does not provide a guaranty for the GSE's historical portfolio function. Instead, we envision that in times of economic crisis, a Government guarantee of a specific class of senior debt (similar to the limited FDIC bank debt guarantee program of 2009) could accomplish this without reinstating the implied U.S. Government guarantee of all CMI debt.

The second key to countercyclicality is to recognize that what is done in good times is just as important as what is done in times of stress. Adequate reserving and building up of capital is critical and can best be achieved using institutional risk taking solutions (rather than structured transactions). Regulatory discipline around pricing and risk management also needs to be imposed on the private market, and should be the charge of a strong regulator.

In any event, the future state model should prioritize what is in the best interest of the overall economy over the long run. These decisions should not be left to a conservator, who has a substantively different mandate.

Comparison to a completely private market

A completely private market alternative is one where all credit risk is borne by private capital. (Technically, the source of funding for all mortgages is "private," but most of it relies on some form of Government credit guarantee in the event of default.)

As the Bipartisan Policy Commission report documents, financing America's housing requires some 10 trillion dollars; attracting adequate capital without a Govern-

[27] This was the minimum statutory capital requirement for off balance-sheet obligations, with a 2.5 percent minimum for on-balance sheet assets; the regulator could and on occasion did require an additional factor (at its highest, +30 percent). The GSEs were also subject to risk-based capital requirements, but these were often lower than the statutory requirement.

ment backstop at that scale would surely be challenging. Commercial banks and savings institutions, which have Federal deposit insurance and, for larger institutions, implicit "too big to fail" backing, only constitute a quarter of this debt, and according to the report, "there is simply not enough capacity on the balance sheets of U.S. banks to allow a reliance on depository institutions as the sole source of liquidity for the mortgage market."[28] Today, the more purely private market is funding less than 20 percent of the rest.[29]

A completely private market would mean a smaller market and a riskier one, and one that would not meet the fundamental requirements of stability and liquidity to support a robust housing market in this country. History has shown us that a housing finance system that relies on private risk-taking will be subject to a level of volatility that is not systemically tolerable, given the importance of housing to the economy and the American family. Moreover, completely private proposals would not achieve stability and, in fact, would expose taxpayers to even more risk from boom-bust cycles such as the one that triggered the financial crisis and that was fueled by recklessness in the private market.

Importantly, even a well-regulated private market would predominantly offer loans with shorter durations and higher costs, while the long-term fixed-rate mortgage would not be available under terms affordable to most families.[30] Likewise, rental housing would be less available to working families and would cost more, even as there is growing demand for it.

Finally, there is the fact that, as demonstrated by the recent financial crisis, the Government has demonstrated that it will step in to prevent a systemic financial collapse regardless of structure. Even champions of a pure-private solution admit, that if that is the case "explicit guarantees with some taxpayer protection may be better than implicit guarantees with no protection."[31] They go on to suggest that "taxpayers should evaluate all proposals for continuing guarantees with their eyes wide open and do what they can to reduce the extent to which they are unwittingly exploited in the future."[32]

We could not agree more. It is time to get to work on devising a system that provides the benefits of Government insurance with minimal risk to taxpayers through the structuring of a stable mix of public and privately administered credit insurance.

Conclusion

From the 1930s through the end of the last century, the United States enjoyed a vibrant, stable, housing market that evolved to provide liquidity for mortgages in all parts of the country through every business cycle. The system was not perfect, but it contains valuable lessons for us as we look to rebuild. By applying those lessons to meet the goals outlined in this testimony, we have the opportunity to build a mortgage market that is fair, accessible, affordable, and fiscally sound, one that works better for more households and communities than ever before.

Thank you for inviting me to talk about the work my colleagues and I have done and I would be happy to answer any questions.

[28] Bipartisan Policy Center Housing Commission, "Housing America's Future," p. 39.

[29] Center for American Progress calculations based on Federal Reserve "Mortgage Debt Outstanding" data, available at *http://www.Federalreserve.gov/econresdata/releases/mortoutstand/current.htm.*

[30] Richard K. Green, Testimony before the Senate Banking Committee, "Housing Finance Reform: Should there be a Government Guarantee?" September 13, 2011, available at *http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore__id=56068079-9c03-40d4-b36a-72913d3850b4.*

[31] Larry D. Wall, W. Scott Frame, and Lawrence J. White, "Will Taxpayers Get a Truly Fair Deal with Housing Finance Reform?" Center for Financial Innovation and Stability Notes from the Vault, March 2013, available at *http://www.frbatlanta.org/cenfis/pubscf/nftv__1303.cfm.*

[32] Ibid.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM MEL MARTINEZ

Q.1. Currently, the U.S. housing finance system is largely comprised of loans insured by the Federal Housing Administration, loans guaranteed by the GSEs, and loans completely underwritten by private capital. Can you explain for us how the Commission's proposed policy would affect the agency-insured, conventional and jumbo loan spaces?

A.1. The commission expects that the single-family housing finance system of the future will have three distinct segments:

1. Mortgages that are not covered by any Government guarantee (including loans held in portfolio and private-label mortgage-backed securities) would comprise a substantial share of the overall market.
2. The market share of mortgages insured or guaranteed by the Federal Housing Administration ("FHA"), the U.S. Department of Veterans Affairs ("VA"), and the U.S. Department of Agriculture ("USDA") would return to pre-crisis levels.
3. Mortgages covered by the new, limited Government guarantee proposed by the commission would make up the balance.

After a suitable transition period, the commission recommends that the loan limits for the two Government-guaranteed markets (#2 and #3 above) be established for each metropolitan area using a formula that takes into account the median house price in that area. Future policy choices by the Administration and Congress will determine the actual loan limits, but looking at historical loan limits before the crash, for many areas these loan limits might be in the range of $150,000 to $175,000 for the share of the market served by FHA, VA, and the USDA, and in the range of $250,000 to $275,000 for the share of the market covered by the new, limited Government guarantee proposed by the commission.

The commission believes a dynamic, flexible transition over an extended period of time (5 to 10 years) will be needed to unwind the single-family operations of Fannie Mae and Freddie Mac in an orderly fashion and rebalance capital flows as the private sector steps in and the Government footprint becomes smaller. A gradual approach will minimize market disruptions and safeguard against the sudden potential loss of access to mortgage credit.

During this transition period, several "policy dials" could be utilized to help reduce the size of Government involvement in the single-family mortgage market. A gradual reduction in the maximum loan limits for Fannie Mae, Freddie Mac, FHA, and VA should serve as the primary policy dial and will provide an indication of the private market's appetite for unsupported mortgage credit risk.

Other policy dials have already been set in motion. The Federal Housing Finance Agency ("FHFA") has recently increased the guar-

antee fees charged by Fannie Mae and Freddie Mac, in order to help move the Government pricing structure closer to the level one might expect if mortgage credit risk were borne solely by private capital, making the private market more competitive. The FHFA has also accelerated the reduction in the portfolios of Fannie Mae and Freddie Mac from 10 percent annually to 15 percent annually. In addition, FHFA has announced its intention to begin experimenting with single-family mortgage-backed security ("MBS") structures to allow a portion of the credit risk currently held by Fannie Mae and Freddie Mac to be sold to the private sector. Although only first steps, experimentation along these lines will enable greater private-sector involvement and set the stage for the transition to the new system.

Another major action that would encourage a greater role for the private sector in the housing finance system would be clarifying the rules of the road going forward. Despite the Consumer Financial Protection Bureau's promulgation of final rules on Qualified Mortgages ("QM") and mortgage servicing, regulatory uncertainty continues to hold back private-sector involvement. The pending rule regarding Qualified Residential Mortgages ("QRM"), along with other outstanding questions related to the Dodd-Frank legislation, must be resolved for the private sector to return to the mortgage market in a more robust manner.

Q.2. The Commission's proposal goes beyond ownership and calls for more Government assistance for rental, especially in low and extremely low-income households. How might the subsidies be structured? Through the tax code? Direct spending?

A.2. More than one-third of all households in the United States rent their homes. The Nation's 41 million renter households account for 35 percent of the U.S. population, and their numbers are likely to grow significantly in the coming years.

With rental demand increasing, rents are rising in many regions of the country. As a result, our Nation's lowest-income renters find themselves spending larger shares of their incomes on housing than ever before. Our Nation's most vulnerable households—those with "extremely low incomes" of 30 percent or less of area median income—are squeezed even further by the huge mismatch between their numbers and the limited number of affordable rental units that are available in the market. In all, Federal rental assistance programs currently help approximately five million American households afford housing. However, because of the lack of resources, only about one in four renter households eligible for Federal rental assistance actually receives it.

The commission proposes to respond to this problem with a multilayered approach that involves improving the performance of existing rental assistance programs, targeting most "direct spending" support to our Nation's most vulnerable households, and utilizing the tax code to support the production, preservation, and rehabilitation of rental units affordable to low-income households.

1. *Improving Performance.* The commission recommends a new performance-based system for delivering Federal rental assistance that focuses less on process and more on achieving positive results for residents. This new system will evaluate a

housing provider's success in achieving outcomes like improved housing quality, enabling the elderly and persons with disabilities to lead independent lives, and greater economic self-sufficiency for assisted households capable of work. This proposed system would devolve responsibility from the Federal Government to State and local decisionmakers, as well as reward high-performing housing providers with substantial deregulation, providing greater freedom to innovate and depart from standard U.S. Department of Housing and Urban Development ("HUD") practices and rules. Substandard providers, on the other hand, would be subject to a competitive process and potential replacement.

2. *Helping the Most Vulnerable Households.* The commission recommends limiting eligibility for the Housing Choice Voucher program to the most vulnerable households, those earning 30 percent or less of area median income. Given today's resource-constrained environment, the commission believes that as families currently enrolled in the program turn back their subsidies and new vouchers are issued, it is appropriate to target assistance to households at the lowest end of the income scale. We recognize this deeper targeting shrinks the pool of eligible beneficiaries, but it was our judgment that this tradeoff is worth making if it means that a greater number of our Nation's most vulnerable households would be assured access to assistance if they need it. To address the needs of families above this income threshold, the commission also recommends providing short-term emergency assistance to low-income renters (those with incomes between 30 and 80 percent of area median income) who suffer a temporary setback such as a health crisis or job loss. This assistance would be delivered through the HOME Investment Partnerships program and could help cover the payment of security deposits, back-rent and other housing-related costs.
3. *Utilizing the Tax Code to Increase the Supply of Affordable Rental Housing.* The commission supports increasing the supply of affordable rental housing by expanding the Low Income Housing Tax Credit ("LIHTC") by 50 percent over current funding levels and providing additional Federal funding to help close the gap that often exists between the costs of producing or preserving LIHTC properties and the equity and debt that can be raised to support them. The commission also recommends additional Federal funding beyond current levels to address the capital backlog in public housing.

In light of today's very difficult fiscal environment, the commission recognizes that a transition period will be necessary before these recommendations can be fully implemented. The commission supports the continuation of tax incentives for home ownership, but as part of the ongoing debate over tax reform and budget priorities, the commission also recommends consideration of modifications to these incentives to allow for increased support for affordable rental housing. Any changes should be made with careful attention to their effects on home prices and should be phased in to minimize any potential disruption to the housing market.

As a final note, the commission recommends retaining in a reformed housing finance system the fee adopted by Congress in the Housing and Economic Recovery Act of 2008 and intended to be collected by the GSEs, to apply only to mortgages guaranteed by the Public Guarantor. Revenue generated should be used to fund the National Housing Trust Fund and the Capital Magnet Fund, with eligible activities to include housing counseling for first-time home buyers and support for affordable rental housing.

Q.3. The Commission's policy recommendation leans toward a system that is comparable to the Ginnie Mae platform that currently securitizes Government insured loans. That model utilizes about 300 lenders who must meet stringent capital requirements to be in the Government-backed securitization market. How might this work in a reformed housing finance framework? Will there be adequate competition and opportunity for small community banks and credit unions?

A.3. That is correct. The housing finance model endorsed by the commission is similar to the Ginnie Mae model.

The commission strongly believes that access to the Government-guaranteed secondary market must be open on full and equal terms to lenders of all types, including community banks and credit unions, and in all geographic areas. Ginnie Mae's success in empowering smaller institutions to access the secondary market through its Ginnie Mae II program is instructive here. Under this program, one or more lenders may pool mortgages in the same security, which allows for a greater diversity of lenders to access the secondary market. The Ginnie Mae II program also enhances access for smaller financial institutions by allowing 1) securities to be issued with fewer mortgage loans than under the Ginnie Mae I program; 2) the pooling of adjustable rate mortgages and mortgages with a wider range of mortgage interest rates; and 3) the guaranteeing of securities backed by pools of manufactured housing loans where the interest rates can vary within a fixed range.

The commission's proposal would also allow for the Federal Home Loan Banks to serve as master issuers of mortgage-backed securities for their community bank members, who would continue to act as the originators and servicers of mortgages.

Q.4. How much more might the risk premium charged to investors need to be in a normally operating market where private capital is in the first-loss position, than is currently charged by the GSEs? Would the FHA supplement this system or another entity? If so, would it do so at all times, or in cases of severe credit constriction?

A.4. While the new housing finance system proposed by the commission will minimize taxpayer risk by placing risk-bearing private capital in the "predominant loss" position, we recognize there is no such thing as a free lunch and that mortgage rates will rise as a result. Private credit enhancers will charge a fee to cover the cost of private capital to insure against the predominant loss if a mortgage default occurs. In turn, the Public Guarantor described in the commission's report will charge an unsubsidized fee to cover catastrophic risk should a private credit enhancer be unable to fulfill its obligations. This approach is far different from past practice in which there was little, if any, connection between actual risk and

the guarantee fees charged by the two GSEs. The Public Guarantor will also charge a fee to cover the cost of its operations.

According to an analysis performed by the well-respected financial research firm, Andrew Davidson & Co., Inc., the commission's proposal would increase mortgage costs for borrowers with no mortgage insurance by approximately 59 to 81 basis points above the baseline interest rate. By comparison, the guarantee fees for mortgages now supported by Fannie Mae and Freddie Mac are approximately 50 basis points above the baseline interest rate (including a 10 basis point charge paid to the U.S. Treasury to finance the payroll tax deduction). What this means is that the actual net cost increase incurred by borrowers under our proposal would likely be in the range of 9 to 31 basis points.

While the commission recognizes the need for further work on the cost implications of its proposal, the estimates we have seen so far represent an acceptable tradeoff between increased costs and greater taxpayer protection.

Since its creation during the Great Depression, the FHA has periodically been called upon to act as a stabilizing force within the single-family market. The FHA has also traditionally been an important source of mortgage credit for first-time home buyers and borrowers with low wealth. Looking ahead, the commission envisions an FHA that continues to play these two roles.

Under normal economic conditions, the commission supports a more targeted FHA that returns to its traditional mission of primarily serving first-time home buyers. This goal can be achieved through the gradual reduction in FHA loan limits to those that existed before the collapse of the housing market. The recent concerns over the solvency of FHA's single-family mortgage insurance fund only underscore the urgency of what the commission has proposed—that far more risk-bearing capital must flow into our Nation's housing finance system. A system in which risk-bearing capital is plentiful will help reduce the pressure that is sometimes placed on the FHA to act as the mortgage-credit provider of last resort and allow it to perform its traditional missions more effectively and at lower risk to the taxpayer.

Q.5. How do we consider reforming the housing finance system considering that the recent CFPB rules on Qualified Mortgages have exempted agency insured and securitized loans? For better or worse, doesn't this imply that the GSEs in their current form would continue to exist for the next several years?

A.5. The commission supports the gradual winding down and elimination of Fannie Mae and Freddie Mac over a multiyear transition period. Although the commission's report does not address the QM exemption for mortgages insured and securitized by the two GSEs, my personal view is that this exemption could be narrowed during the transition period (for example, by reducing the GSE loan limits) as a way of reducing any regulatory advantage that the GSE-backed mortgage market may enjoy over the purely private market. Alternatively, as the operations of the two GSEs are wound down, a QM exemption could also be provided to mortgages that have met the baseline underwriting standards established by the Public Guarantor described in the commission's report.

On a related issue, and speaking for myself only, it is critical that the QM rule and the pending QRM rule be aligned so that what constitutes a QM also qualifies as a QRM. Aligning the QRM and QM standards so that they work together—and not at cross-purposes—will reduce uncertainty, while promoting prudent mortgage lending. However, if Federal regulators ultimately decide to maintain the stringent downpayment and other restrictive requirements found in the proposed definition of QRM, they will add to the confusion in the marketplace and encourage more private capital to retreat to the sidelines.

Q.6. We already have a number of Federal regulatory agencies that oversee the housing and mortgage finance, as well as related State laws and agencies. In terms of overseeing a reformed housing finance platform—whether wholly private or with Government involvement—how should regulation be handled?

A.6. The commission proposes to replace the GSEs with an independent wholly owned Government corporation, the "Public Guarantor," that would provide a limited catastrophic Government guarantee for both the single-family and rental markets. Unlike the GSEs, the Public Guarantor would not buy or sell mortgages or issue mortgage-backed securities. It would simply guarantee investors the timely payment of principal and interest on these securities. As you point out, the model endorsed by the commission is similar to Ginnie Mae, the Government agency that wraps securities backed by federally insured or guaranteed loans. Other than the Public Guarantor, all other actors in the new system—originators, issuers of securities, credit enhancers, and mortgage servicers-should be private-sector entities fully at risk for their own finances and not covered by either explicit or implicit Government guarantees benefiting their investors or creditors.

In this new system, the Public Guarantor would have significant standard-setting and counterparty oversight responsibilities. These responsibilities include qualifying institutions to serve as issuers, servicers, and private credit enhancers; 2) ensuring that these institutions are well capitalized; 3) establishing the guarantee fees to cover potential catastrophic losses; 4) ensuring the actuarial soundness of the two catastrophic risk funds for the single-family and rental segments of the market; and 5) setting standards (including loan limits) for the mortgages backing Government-guaranteed securities. With respect to rental finance, the Public Guarantor would also have the authority to underwrite multifamily loans directly and would be responsible for establishing an affordability threshold that would primarily support the development of rental housing that is affordable to low- and moderate-income households.

As a Government corporation, the Public Guarantor will be a self-supporting institution that does not rely on Federal appropriations but rather finances the two catastrophic funds and its own operational expenses through the collection of guarantee fees. The Public Guarantor should operate independently of any existing Federal department and, with this greater independence, should be able to respond more quickly to contingencies in the market and operate with greater efficiency in making staffing, budgeting, pro-

curement, policy, and other decisions related to mission performance.

To ensure continuity and build on existing Government capabilities, Ginnie Mae—enhanced with greater authorities and flexibilities—could assume the role of the Public Guarantor. In that case, Ginnie Mae would be removed from HUD, spun out as a separate and independent institution, and given the necessary authorities so that it could successfully discharge its responsibilities, including performing its traditional function as the guarantor of MBS backed by loans insured by the FHA, VA, USDA, and HUD's Office of Public and Indian Housing.

The commission recommends that the Public Guarantor be led by a single individual, appointed by the President of the United States and confirmed by the U.S. Senate, who would serve a director. The commission also recommends the establishment of an Advisory Council to the Public Guarantor consisting of the chairman of the Board of Governors of the Federal Reserve System as chairman of the Council, along with the director of the Public Guarantor, the secretary of the U.S. Department of the Treasury, and the secretary of HUD. The Advisory Council would meet on at least a quarterly basis to share information about the condition of the national economy, marketplace developments and innovations, and potential risk to the safety and soundness of the Nation's housing finance system.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM PETER J. WALLISON

Q.1. You speculate that the Treasury's ownership of preferred stocks in the GSEs has potentially limited the ability of either Fannie or Freddie to retain enough earnings to grow their operations and ultimately move out of conservatorship. Could you elaborate for us?

A.1. The key question is whether Fannie and Freddie can move out of the conservatorship as GSEs. The longer they remain in the conservatorship and central to the liquidity of the housing market, the more likely it will be that Congress will eventually restore them to their former roles as GSEs. To do that, they will have to be capitalized. The fact that all their earnings are now paid to the Treasury means that they cannot generate any capital internally. Thus, to return as GSEs they will have to be attractive enough as investments to find private capital. On the other hand, if they were able to retain their profits, they would become very valuable. They would not need to raise private capital to operate. The common and preferred stock (that is, the preferred stock not held by treasury) are still outstanding and are owned by speculators who have been and will be urging Congress to restore their franchise as GSEs. If that happens, these speculators will reap substantial profits. But if Fannie and Freddie have no capital and have to be recapitalized before they can leave the conservatorship, the speculators will lose interest and there will be less pressure on Congress to restore their GSE franchises.

Q.2. You critique proposals that include a Government back-stop to a mostly private system, as being a driver of lower quality mort-

gages; mainly because it would reduce investor risk. How does this idea hold up in a post QM/QRM secondary market? Isn't mortgage underwriting already more rigorous today than what existed prior to the finance meltdown?

A.2. To some extent, yes. Negative amortization mortgages, no doc-low doc mortgages and interest only mortgages are now prohibited. However, it is an illusion to believe that subprime and other low-quality mortgages have been prohibited by QM. In fact, they have been encouraged. The traditional prime mortgage had a substantial downpayment, a good borrower credit score at 660 or above, and a low debt-to-income ratio in the mid-to-high 30s at the back end. Mortgages like this had less than a 1 percent default rate. However, the QM requires neither a downpayment nor a good credit score, and the DTI is now as high as 43 percent. The only question under QM (apart from the price of the loan) is whether the buyer can afford the mortgage at the time of the commitment. That does not take account of any of the vicissitudes of life, such as job losses, illness, recessions, divorce, etc that occur after the closing. Moreover, the lender gets safe harbor protection for an even higher DTI if the mortgage is approved by the automated underwriting systems of the GSEs or FHA. This means that as long as the lender can get the approval of a Government AUS it can make a mortgage to a borrower who makes a 3 percent downpayment, and has a 580 credit score and a 50 percent DTI at the back end. The FHA insures these mortgages today. Loans like this used to be called subprime loans, and have a 25 percent default ratio over the usual 10 year cycle. In a competitive market, that's where the lenders will go, and the Government will approve these mortgages through the GSEs and FHA, so the lenders can claim the safe harbor. We also know that the Government will institute polices to push for even weaker credit standards. We have just recently seen evidence of this as the FHA actively encourages lenders to originate loans that have a 15, 20, even, 25 percent chance of foreclosure-all of which will receive the benefit of the safe harbor. Over time, because of the poor quality of the mortgages that will result, we will have another meltdown like 2007 and 2008. A Government backstop, as I said in my testimony, will only make things worse, since it eliminates any reluctance on the part of investors to buy MBS based on these subprime and low-quality mortgages. The investors know that the Government will bail them out.

Q.3. In a recent Wall Street Journal article, you offer that some of the origins of the subprime meltdown were the 1992 Community Reinvestment Act (CRA) and recent increases in the mortgage limits at the GSEs and FHA. While there is no doubt larger than normal volumes of nonperforming loans in these organization's portfolios, doesn't research show that CRA and higher value loans actually perform quite well?

A.3. No. Actually, to be precise, CRA was only one of the factors that contributed to the mortgage meltdown and the financial crisis. The affordable housing goals placed on the GSEs were a larger and more important factor. Nevertheless, in my view, the analyses that have been done of CRA loans are wrong, and I believe were skewed to satisfy the supporters of CRA in Congress and elsewhere. First,

the analyses covered only high cost loans, but most banks that make CRA loans have to cross-subsidize them, so the loans are not high cost and were not considered in the Fed's study. Second, the conclusion of the Fed's study was that CRA loans didn't perform any worse than subprime loans generally. That isn't what anyone would call "quite well." Third, if you want to know how CRA loans perform look at the CRA-eligible loans acquired by Fannie and Freddie. These two firms became insolvent and had to be bailed out by the taxpayers even though they made efforts to buy only the best of the subprime loans available to them, and actively sought to acquire CRA loans from banks.

Q.4. Is it not accurate to say that Fannie and Freddie were not originating subprime loans, but were simply buying subprime backed, private label securities for the same reason other buyers were in the mid-2000s, because they were profitable in the short-term, not because of Government mandates? As a prime mover in the past mortgage securities bubble, shouldn't we be more suspect of purely private housing finance systems? Hasn't the private market shown at least an equal inability to accurately price risk with the public sector, whether through negligence or even worse, a tendency to misstate risk for gain of profit?

A.4. I do not defend what the private sector did in the years leading up to 2008, but I contend—and the data show—that the primary cause of the mortgage meltdown and the financial crisis was the Government's housing policies. In fact, without these policies I do not believe there would have been a financial crisis. The private sector makes mistakes and always will, but when their mistakes are serious enough they go into bankruptcy and disappear; only the Government can create a problem so large that it causes a financial crisis. What the private sector was doing, apart from the Government's activity, was simply too small to affect the larger economy. By 2008, half of all mortgages in the United States—28 million loans—were subprime or Alt-A. Of that 28 million, 74 percent were on the books of Government agencies like the GSEs and FHA. That shows where the demand for these loans came from, and they wouldn't have been made without that demand. It should be obvious that you can't just originate junk and sell it; there has to be a willing buyer, and in the overwhelming number of cases that buyer was the Government, particularly Fannie and Freddie. The private MBS based on subprime and Alt-A loans helped the GSEs meet the affordable housing goals. If these loans were so profitable, Fannie and Freddie would have bought as many as they could, but the data shows that as the AH goals rose their purchases of subprime loans also rose, never exceeding the applicable goal by very much. And in the end, of course, they became insolvent from buying these "profitable" loans. It is also an urban myth that the only subprime loans they bought were in private MBS. In reality, by 2008, the GSEs held or had guaranteed a total of $1.84 trillion in subprime and Alt-A loans. These were whole loans that they had purchased and either held in portfolio or securitized. At the same time, they held only $121 billion in subprime loans and $72.6 billion in Alt-A loans (a total of $193.6 billion) that were backing privately issued MBS. In other words, the subprime and Alt-A loans

in privately issued MBS were only a little more than 10 percent of the total exposure of Fannie and Freddie to these low quality loans.

Q.5. What role would quality housing counseling play in a reformed housing finance system? Couldn't it help with ensuring that mortgage consumers don't face an 'information disadvantage' like they faced in the subprime crisis?

A.5. It could help, but it's marginal. People want to buy homes and if they are offered the opportunity and believe they can afford it, they will ignore counseling or rationalize it.

Q.6. How do we consider reforming the housing finance system considering that the recent CFPB rules on Qualified Mortgages have exempted agency insured and securitized loans? For better or worse, doesn't this imply that the GSEs in their current form would continue to exist for the next several years?

A.6. Yes, but the law can be changed. Dodd-Frank, the CFPB and Qualified Mortgages are not immutable. If Congress were to require, for example, that the GSEs can only approve or acquire prime mortgages, much would change.

Q.7. We already have a number of Federal regulatory agencies that oversee the housing and mortgage finance, as well as related State laws and agencies. In terms of overseeing a reformed housing finance platform—whether wholly private or with Government involvement—how should regulation be handled?

A.7. The answer depends entirely on what form of housing finance system is adopted. If the BPC system is adopted, a lot of new regulation will be required, because all the issuers of the MBS backed by the Government will have to be regulated to make sure that they remain well-capitalized. This is necessary because the investors in the MBS will not care about the quality of the underlying mortgages, nor will the creditors of the issuers, who will assume that they will be bailed out by the Government if one or more of the issuers fails. The BPC itself proposes that the guarantor of the MBS would be the regulator. On the other hand, if the plan I outlined were to be adopted, the only regulation necessary would be a requirement that only prime loans be securitized. That could be done by FHFA.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM JANNEKE RATCLIFFE

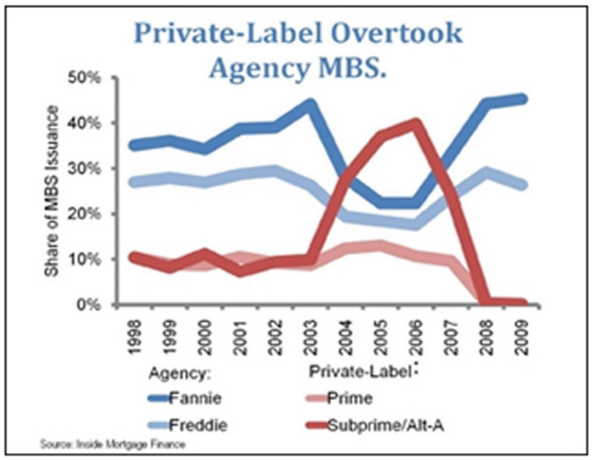
Q.1. Can you describe for us the role of "shadow banking units" in the mortgage finance space prior to 2008? What effect did they have on mortgage underwriting standards?

A.1. This interesting question has been the subject of much literature on the crisis and financial sector. While purely private "shadow banking units" had little to do with the Government-Sponsored Entities (GSEs), shadow banks did have a significant role in the crisis.

Shadow banks were part of what the Financial Crisis Inquiry Commission Report calls "the runaway mortgage securitization

train."[1] The shadow banking system's lack of transparency, huge leverage and debt loads, short-term loans, and risky assets were the rickety foundation that crumbled when housing prices fell and mortgage markets seized up. It is most likely true that if shadow banks had not provided the liquidity and capital to buy up mortgage securities and real estate backed assets, the market would not have been quite so frenzied, and mortgage-underwriting standards would not have fallen quite so dramatically.

Meanwhile, as the chart below shows, the GSE's lost share to the pure private sector during the bubble period.



One illuminating aspect of the housing bubble and crisis was that the Government-Sponsored Enterprises (GSE) maintained somewhat higher mortgage underwriting standards than the rest of the market, and the mortgages they securitized and loans they held defaulted at a much lower rate than the private market. From 2004 to 2006 in particular, well over 70 percent of GSE purchases were low risk loans, compared to well under half of private label securitized loans, while the PLS sector originated a greater share and volume of high-risk loans than the GSEs. While it is thus not surprising that the PLS market experienced default levels three to four times the those of the GSEs for those years' books of business, what is instructive is that even within each risk category (of LTV, credit score and loan type) the GSE's loans performed better than PLS loans within the same risk category.[2]

Moreover, loans originated through the shadow banking system were more likely to be adjustable rate, option-ARMS, broker originated, and to carry risky features such as no documentation and prepayment penalties. Analysis by UNC finds that these features are strongly associated with higher likelihood of default, compared

[1] *http://fcic.law.stanford.edu/report* (FCIC Report).

[2] FHFA, Data on the Risk Characteristics and Performance of Single Family Mortgages Originated from 2001 through 2008 and Financed in the Secondary Market. September 13, 2010. *http://www.fhfa.gov/webfiles/16711/RiskChars9132010.pdf.*

to similar borrowers who are given prime, well underwritten, fixed-rate mortgages.[3]

The evidence suggests that unregulated shadow banks helped fuel the lowering of mortgage underwriting standards and the subsequent default crisis.

Q.2. Are a 20 percent downpayment, established credit, and low debt-to-income the best indicators of loan performance? Can well documented, prime loans be written for households that cannot meet these traditional loan requirements, and still perform?

A.2. The headline takeaway from this hearing should be that many good, safe loans have been (and can be) made with low downpayments and nontraditional ways to verify creditworthiness. There is some correlation between loan performance and established traditional credit and high downpayment. While these characteristics may seem appealing as indicators of loan performance, they should not be taken as the only way, and certainly not the best way, to measure the safety and soundness of loans.

As a case in point, the UNC Center for Community Capital has tracked the performance of nearly 50,000 loans to low wealth, lower income borrowers, funded beginning in 1999, through a special program offered by a community development financial institution (Self-Help) and Fannie Mae. These loans were originated by banks around the country. The median borrower earned around $35,000 at origination, and more than half the borrowers put down *less than 5 percent.* Yet this portfolio has performed relatively well, especially considering the circumstances the borrowers have lived through over the last several years. The default rate on these loans has been below that for prime ARM loans, and well below that for subprime loans. These low downpayment borrowers have broadly managed to maintain home ownership and even build some equity, depending on their timing, even during a period of extreme volatility in real estate values and economic conditions.[4]

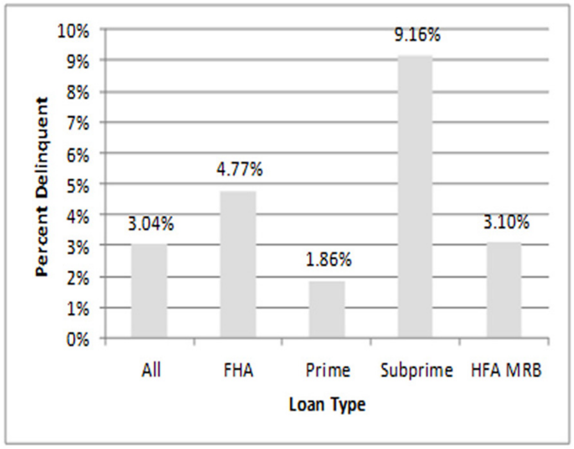
That is not the only case of low downpayment mortgages being done safely. For example, the Nation's State housing finance agencies (HFAs) have served low downpayment, first-time home buyers for decades. The chart below compares the performance of HFA mortgage revenue bond loans (HFA MRB) to other types of loans, and shows that despite the high loan to values, the HFA loans have performed on a par with all loans and much better than subprime.[5]

[3] Ding, Lei, Roberto Quercia, Wei Li and Janneke Ratcliffe. Risky Borrowers or Risky Mortgages. Disaggregating Effects Using Propensity Score Models. Journal of Real Estate Research 2011, Vol. 33, No. 2, pp. 245–278 May, 2010.

[4] Quercia, Roberto, Allison Freeman and Janneke Ratcliffe. *Regaining the Dream: How to Restore the Promise of Homeownership for America's Working Families.* The Brookings Institution. 2011.

[5] Moulton, Stephanie and Roberto Quercia, 2013, *forthcoming.* Access and Sustainability for First Time Homebuyers: The Evolving Role of State Housing Finance Agencies.

% Loans 90+ Days Delinquent as of June 30, 2012



Source: Mortgage Bankers Association (MBA) National Delinquency Survey Q3, 2012; compared to HFA self-reported loan performance data per 2012 author survey of State HFAs; N=30 HFAs with loan performance data. Moulton and Quercia (2013).

As we consider what makes loans healthy and the housing market sustainable, we must recognize that there is a crucial tradeoff between risk and access. Mandating simplistic, one-dimensional underwriting rules ignores the balance between risk and access. The UNC Center for Community Capital estimated that requiring a 20 percent downpayment would exclude 60 percent of creditworthy borrowers from the housing market.[6] Putting too much stock into the 20 percent downpayment, or onto a specific agency's estimated credit score has the potential to seriously block the home ownership hopes of millions of families without accumulated wealth and easy access to credit and prevent them from getting a sustainable and low-risk mortgage. Instead, lenders should be encouraged to underwrite carefully and to offer safe products to mitigate the risks facing borrowers with smaller equity cushions.

Q.3. Millions of Americans face foreclosure, many with fixed-rate loans, due to economic reasons beyond their control. That is, they did not take out exotic or unreasonable loans—but are feeling the market effects from those that did—due to high unemployment and foreclosure. Considering this point, is it possible that our housing finance market needs some flexible lending products like lease-purchases, risk shared loans, or shared equity loans that might preserve affordability and spread risk between the investor and borrower—without fully relying on Government backing?

A.3. High unemployment brought about by the foreclosure crisis is certainly negatively impacting the lives of millions of Americans. Nevertheless, many homeowners successfully sustained home own-

[6] Quercia, Roberto, Lei Ding, Carolina Reid. Balancing Risk and Access: Underwriting Standards for Qualified Residential Mortgages. January, 2012. *http://www.ccc.unc.edu/abstracts/QRMunderwriting.php.*

ership throughout this crisis, even those with low downpayments and nontraditional credit histories and that having a safe product has proven to provide some protection.

Lending products like lease-purchases, risk shared loans, or shared equity loans are certainly one set of solutions that could allow some households to safely navigate home ownership, but they are not the products on which to build the entire U.S. housing market. These innovative products work best in niche markets that complement the standard loan market. There are a number of homeowners who are otherwise fully qualified for ownership (stable income, good credit, *etc.*) but lack family wealth for the downpayment. In the shared equity approach, a governmental or nonprofit finance source partners with that homeowner by providing some or all of the necessary downpayment, and shares in future appreciation of the home. The terms of the arrangement are intended to be a balance between a reasonable long-term share of appreciation to the homeowner, while keeping the house affordable to the next low/moderate-income home buyer. This approach can also be used for underwater borrowers as part of a restructuring.[7]

During the foreclosure crisis, shared equity home ownership consistently showed very low foreclosure rates even though the borrowers were similar in income, wealth and other characteristics as many of the homeowners subject to predatory lending. Community land trusts in particular reduced foreclosure rates to under 1 percent.[8]

One study by the Center for American Progress estimated that if even a reasonable amount of annual Federal spending on home ownership were channeled into shared equity ownership over the course of 5 years, "a one-time investment of $5 billion could make home ownership possible for between 600,000 and 1.5 million families over a 30-year period, based on typical rates of turnover, and depending upon size of initial subsidy."[9]

This is just one example of the need for avenues for safe innovation through research and development, activities that can be fostered with a properly structured secondary market. The Mortgage Finance Working Group proposes creating a new Market Access Fund that provides funding and a platform to quickly and efficiently collect data on such innovative loan products, which will allow market participants to build best practices and a foundation of experience for offering these new products.[10]

It is also important to remember that the housing crash was much worse than it had to be, and one important reason it was so devastating is that mortgage servicing was not up to the task. Much has been learned about how to service distressed loans to minimize foreclosures and investor losses. Many who lost their homes were not given access to lower rate refinances, principal reductions, and other loss mitigation actions. In fact, even at this

---

[7] *http://www.americanprogress.org/wp-content/uploads/issues/2008/04/pdf/shared_equity.pdf.*
[8] *http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/hbtl_lubell.pdf,* at pp 10.
[9] *http://www.americanprogress.org/wp-content/uploads/issues/2010/02/pdf/shared_equity.pdf.*
[10] *http://www.americanprogress.org/issues/housing/report/2011/01/27/8929/a-responsible-market-for-housing-finance/* (MFWG Proposal).

time, more can and should be done to enable performing borrowers to get out of onerous loan terms.

Q.4. What role would quality housing counseling play in a reformed housing finance system? Couldn't it help with ensuring that mortgage consumers don't face an 'information disadvantage' like they faced in the subprime crisis?

A.4. Housing counseling could play an important role in a reformed housing finance system. In particular, the Bipartisan Policy Center's Housing Commission identifies the HUD Housing Counseling Assistance Program as an exemplary public-private partnership, which shows how to use counseling as a credit enhancer to help underserved communities access credit and home ownership.[11] The housing counseling system, as it exists today, is a great tool, or enhancement, for getting people into safe mortgages.

Counseling can reduce the risk of default. Previous studies suggests that counseling is effective at reducing default and delinquency, though the magnitude and explanations were mixed.[12] [13] Two newer studies provide empirical evidence that prepurchase counseling can reduce default rates by around 30 percent. Brand new research from Freddie Mac shows large and significant effects of housing counseling on reducing delinquency. Zorn *et al.* (2013) (Freddie Mac) found that counseling reduces delinquency by 29 percent for first-time home buyers, and estimated the dollar benefit of counseling in reducing risk to be about $1,000.[14] Similarly, Mayer *et al.* found that clients who used Neighborworks housing counseling were one third less likely to become 90+ days delinquent on their homes.[15]

Counseling and education is not a simple solution, however. While housing counseling is beneficial, it cannot substitute for good products, good servicing, and consumer protection. Counseling also faces significant resource limitations. Despite the demand for counseling increasing from 250,000 to nearly 2 million annual counseled households over the past 15 years, the counseling system, which is characterized by nonprofit, HUD-approved counselors, often lacks financial resources.[16] The challenge for the future will be obtaining sufficient funding and scaling up infrastructure to meet growing demand for counseling.

Q.5. How do we consider reforming the housing finance system considering that the recent CFPB rules on Qualified Mortgages have exempted agency insured and securitized loans? For better or worse, doesn't this imply that the GSEs in their current form would continue to exist for the next several years?

A.5. This is a very important question to consider when constructing a reformed housing finance system. CFPB's Qualified Mortgage rule was written with the current system, notably the

---

[11] *http://bipartisanpolicy.org/sites/default/files/BPC__Housing%20Report__web__0.pdf* (BPC Report).

[12] *http://www.housingamerica.org/RIHA/RIHA/Publications/76378__10554__Research__RIHA__Collins__Report.pdf.*

[13] Agarwal, Sumit, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet, and Douglas D. Evanoff. 2009. Do Financial Counseling Mandates Improve Mortgage Choice and Performance? Evidence from a Legislative Experiment. SSRN eLibrary.

[14] Zorn, Avila, & Nguyen. The Benefits of Pre-Purchase Homeownership Counseling.

[15] *http://www.nw.org/network/newsroom/documents/ExperianMayer__FullReport.pdf.*

[16] *http://huduser.org/portal/publications/hsg__counsel.pdf.*

GSE's, in mind. We generally applaud the acceptance of loans underwritten through the AUS systems of the GSEs as Qualified Mortgages, provided those AUS systems are carefully monitored for quality and fairness and that the underwriting exceptions are coupled with proven, safe product features. Though it may need to be rewritten, the QM rule's core could be extended into a post-GSE world as long as it accepts underwriting decisions made by a qualified Automated Underwriting System. The key is to ensure that there is strong independent validation and oversight of any such approved system, coupled with real risk exposure on the part of the sponsor of such systems.

Q.6. We already have a number of Federal regulatory agencies that oversee the housing and mortgage finance, as well as related State laws and agencies. In terms of overseeing a reformed housing finance platform—whether wholly private or with Government involvement—how should regulation be handled?

A.6. We have seen the results of markets with patchwork, conflicting regulation on multiple levels, and it failed. The Financial Crisis Inquiry Report details the way that Government permitted financial firms to choose which regulators oversaw them in what was described as "a race to the weakest supervisor."[17] As irresponsible lending and fraud became pervasive, the Federal Reserve was slow to act, State regulators were often preempted by Federal agencies,[18] and the Office of the Comptroller of the Currency and the Office of Thrift Supervision held turf wars over regulation.

An important principle of housing finance reform should be unifying regulatory oversight over the whole market. The Mortgage Finance Working Group (MFWG) and BPC's Housing Commission have similar conceptualizations for how to handle regulation.[19] [20] Both see three important levels with slightly different names: mortgage and securities issuers, Chartered Mortgage Institutions/ private credit enhancers, and a Catastrophic Risk Insurance Fund/ Public Guarantor. In both cases, the Government entity responsible for insuring catastrophic risk would also set standards for product structure, underwriting and servicing, in line with national servicing standards. The BPC's Government entity would also provide a charter or qualification for issuers, servicers, and credit enhancers. The private credit enhancers would provide regular and detailed reports to the Government entity, which would also administer quarterly stress tests to ensure they have a sufficient amount of capital to withstand shocks to housing prices. Both scenarios also propose funding the Government entity through guarantee fees on insured securities, which could serve as the funding mechanism for the overarching market regulator.

[17] FCIC Report.
[18] Ding, Lei, Roberto Quercia, Carolina Ried and Alan White. August, 2010. The Impact of Federal Preemption of State Anti-Predatory Lending Laws on the Foreclosure Crisis. *http://www.ccc.unc.edu/documents/Preemption_final_August%2027.pdf.*
[19] MFWG Propopsal.
[20] BPC Report.